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In The

Supreme Court of the United States

October Term, 1995

OMNITRITION INTERNATIONAL, INC., JAMES FOBAIR, ROGER DALEY and CHARLES RAGUS,

Petitioners,

vs.

SHAUN WEBSTER and ROBERT LIGON,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

Section 2(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 provide, in nearly identical definitions, that the term "security" means, among other things, an "investment contract." In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter of a third party." *Id.* at 298-99. The questions presented for review are:

1) Whether the United States Court of Appeals for the Ninth Circuit correctly substituted "vertical commonality," the relationship between an investment's promoter and the investor, for the "common enterprise" requirement of *Howey*, or whether, as the Court of Appeals for the Second, Third, Sixth and Seventh Circuits have held, there must be "horizontal commonality" among investors in a central business venture to create an investment contract; and

2) Whether the Ninth Circuit erred in allocating the burdens of proof under Rule 56 of the Federal Rules of Civil Procedure ("FRCP") – by requiring Petitioners as defendants moving for summary judgment to produce evidence that their company is not an illegal pyramid scheme, contrary to this Court's holding in *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986).

QUESTIONS PRESENTED FOR REVIEW – Continued

Petitioners show below that the decision of the Ninth Circuit conflicts with this Court's decisions in *Howey* and related investment contract cases and deepens the "split" among the Courts of Appeals regarding "vertical" and "horizontal" commonality. Its procedural holding effectively creates a legal presumption that legitimate multi-level products-distribution companies are "illegal pyramid schemes."

PARTIES TO THE PROCEEDINGS

The parties to the proceedings below were Petitioners Omnitrition International, Inc., James Fobair, Roger Daley and Charles Ragus; Respondents Shaun Webster and Robert Ligon; and Jerry Rubin, Douglas Adkins and Gardere & Wynne, Defendants-Appellees below. Mr. Rubin is deceased. The court of appeals affirmed summary judgment in favor of Defendants-Appellees Adkins and Gardere & Wynne on all federal law claims and directed the district court to determine whether the Plaintiffs' state law claims against them should be dismissed for lack of supplemental jurisdiction under 23 U.S.C. § 1366.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED FOR REVIEW i

PARTIES TO THE PROCEEDINGS iii

TABLE OF AUTHORITIES vi

OPINION BELOW 1

JURISDICTION 1

STATUTORY PROVISIONS INVOLVED 1

STATEMENT OF THE CASE 2

REASONS FOR GRANTING THE WRIT 4

THE COURT OF APPEALS' DECISION DEEPENS THE "SPLIT IN THE CIRCUITS" OVER THE "COMMON ENTERPRISE" ELEMENT OF THE *HOWEY* TEST 6

A. The Real Estate Cases: No Common Enterprise Among Separate Owners Without Horizontal Commonality, but Only in the Second, Sixth and Seventh Circuits 8

B. The Brokerage Account Cases: No Common Enterprise Among Separate Brokerage Accounts, Despite Management by the Same Broker, in the Third, Sixth and Seventh Circuits, but a Single Account Is a "Common Enterprise" in the Ninth Circuit and Separate Accounts Are a "Common Enterprise" in the Fifth Circuit 11

C. The Instant Case: A "Common Enterprise" Created by a Mere "Recruitment Focus" Is "Vertical Commonality" Ad Absurdum 14

TABLE OF CONTENTS – Continued

Page

THE NINTH CIRCUIT'S DECISION IS IN DIRECT CONFLICT WITH SUPREME COURT PRECEDENTS CONCERNING THE DEFINITION OF AN INVESTMENT CONTRACT 15

A. The Ninth Circuit Conflicts with *Howey* in this Case, as a Result of Its New Test for a "Security." 15

B. This Court's Decisions Following *Howey* and *Joiner* Require a Horizontal "Common Enterprise," and Are Inconsistent with "Vertical Commonality." 19

C. The Ninth Circuit Ignored the Basic Principles Underlying this Court's Precedents in Discarding the "Common Enterprise" Requirement in this Case 21

THE COURT OF APPEALS IMPROPERLY IMPOSED THE SUMMARY JUDGMENT BURDEN OF PRODUCTION UPON PETITIONERS AS DEFENDANT-MOVANTS, CONTRARY TO THE *CELOTEX* HOLDING 23

CONCLUSION AND PRAYER 30

TABLE OF AUTHORITIES

Pages

CASES

Adickes v. Kress, 398 U.S. 144 (1970) 26

Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311 (S.D. Ohio 1979) 13

Brodt v. Bache & Co., Inc., 595 F.2d 459 (9th Cir. 1978) 11

Cameron v. Outdoor Resorts of America, Inc., 608 F.2d 187 (5th Cir. 1979) 9

Celotex Corp. v. Catrett, 477 U.S. 317 (1986) ..... *passim*

Curran v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980) 13

FTC v. Koscot Interplanetary, Inc., 86 FTC 1106 (1975) 6

Hart v. Pulte Homes Corp., Inc., 735 F.2d 1001 (6th Cir. 1984) 7, 10

Hocking v. Dubois, 839 F.2d 560 (9th Cir. 1988) 7

In re Amway Corp., 93 FTC 618 (1979) 3, 25

Long v. Schultz Cattle Co., 881 F.2d 129 (5th Cir. 1989) 12, 14

Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1961) 6

Marine Bank v. Weaver, 455 U.S. 551 (1982) 18, 20

McGill v. American Land & Exploration Co., 776 F.2d 923 (10th Cir. 1985) 7

Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) 7

Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972) 10, 13, 14

TABLE OF AUTHORITIES – Continued

Pages

Mordaunt v. Incomco., 469 U.S. 1115 (1985) 4

Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385 (6th Cir. 1989) 4, 10

Revak v. SEC Realty Corp., 18 F.3d 81 (2d Cir. 1994) 8

Reves v. Ernst & Young, 494 U.S. 56 (1990) 21, 22

Salcer v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459 (3d Cir. 1982) 7, 14

SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943) ..... *passim*

SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) 7, 12, 13

SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, *cert. denied*, 414 U.S. 821 (1973) 6, 14, 16

SEC v. Koscot Interplanetary, 497 F.2d 473 (5th Cir. 1975) ..... *passim*

SEC v. United Benefit Life Insurance Company, 387 U.S. 202 (1967) 20, 21

SEC v. Variable Annuity Life Insurance Co., 359 U.S. 65 (1959) 19

SEC v. W.J. Howey Co., 328 U.S. 293 (1946) ..... *passim*

Shaun Webster and Robert Ligon v. Omnitrition International, Inc., et al., 79 F.3d 776 (9th Cir. 1996) 1

Tcherepnin v. Knight, 389 U.S. 332 (1967) 19, 20, 21

Turner v. FTC, 580 F.2d 701 (D.C. Cir. 1978) ..... *passim*

TABLE OF AUTHORITIES – Continued

Pages

Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121 (11th Cir. 1983) 7

Wals v. Fox Hills Development Corp., 24 F.3d 1016 (7th Cir. 1994) 7, 10

STATUTES

15 U.S.C. §77b 1

15 U.S.C. §78j 1

28 U.S.C. §1254 1

PETITION FOR A WRIT OF CERTIORARI

Petitioners Omnitrition International, Inc., James Fobair, Roger Daley and Charles Ragus respectfully request a writ of certiorari be issued to review the judgment of a panel of the United States Court of Appeals for the Ninth Circuit in this action issued on March 4, 1996.

OPINION BELOW

Review is sought of a decision of a panel of the United States Court of Appeals for the Ninth Circuit, issued on March 4, 1996. The opinion is reported under the caption *Shaun Webster and Robert Ligon v. Omnitrition International, Inc., et al.*, 79 F.3d 776 (9th Cir. 1996). Copies of the opinion, judgment and orders denying the petitions for rehearing and suggestion for rehearing *en banc* are attached in the Appendix to this Petition.

JURISDICTION

The decision of the United States Court of Appeals for the Ninth Circuit was filed on March 4, 1996. Petitioners timely filed a petition for rehearing, with suggestion for rehearing en banc, which was denied on April 23, 1996. On April 18, 1996, the Ninth Circuit denied the Petition for Rehearing of Defendants-Appellees Douglas Adkins and Gardere & Wynne. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

The case involves section 2(1) of the Securities Act, 15 U.S.C. §77b, and section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. §78j. The relevant part of each statute provides, in terms identical for these purposes:

> When used in this subchapter, unless the context otherwise requires

> (1) The term "security" means any note, stock, treasury stock, bond . . . investment contract . . . or, in general, any instrument commonly known as a "security,". . . .

This case also involves Rule 56 of the FRCP, which provides:

> **Rule 56. Summary Judgment**
> **(b) For Defending Party.** A Party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in the party's favor as to all or any part thereof.
> **(c) Motion and Proceedings Thereon.** . . . The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

STATEMENT OF THE CASE

This case involves claims by a class of participants in a multi-level marketing ("MLM") program operated by Petitioners Omnitrition International, Inc. ("Omnitrition") and Roger Daley, and formerly by James Fobair, Roger Daley, and Charles Ragus. Participants in such programs (here called "independent marketing associates" or "IMAs"), do not acquire a share of the overall enterprise or the earnings of the company, nor do they typically make an investment of money (other than an initial investment in products for resale which, as here, are returnable). Instead, IMAs earn money through their own efforts in selling products to retail end-users, or in commissions (here, called "royalty overrides") on the orders of other IMAs that they recruit and supervise. Omnitrition sells nutritional supplements and personal care products.

As noted by the Court of Appeals, Omnitrition has three "anti-pyramiding" policies, now standard in the industry, designed to encourage retail sales and assure that IMAs do not focus excessively on the recruitment of new IMAs. These policies are known as the "Amway safeguards," after the seminal case ruling that these policies distinguish MLMs from illegal pyramid schemes, *In re Amway Corp.*, 93 FTC 618 (1979). These safeguards require that:

(1) IMAs must certify sales of at least 70% of the products previously purchased;
(2) IMAs must personally make sales to at least ten retail customers per month; and
(3) Omnitrition will buy back unsold inventory at 90% of invoice price.

Respondents Shaun Webster and Robert Ligon are former Omnitrition IMAs. Disappointed with their earnings, they each filed a class action alleging that Petitioners operate a pyramid scheme illegal under both state and federal law. The two actions were consolidated in the United States District Court for the Northern District of California, which certified the class. Their amended complaint asserted claims under the federal securities laws, the Racketeer Influenced and Corrupt Organizations Act ("RICO") and California "endless chain" and fraud laws.

The district court granted summary judgment for Petitioners on the ground that Respondents had failed to demonstrate a triable issue of fact on any of their claims. In particular, the district court determined that there is no evidence that Omnitrition distributorships are "investment contracts" within the meaning of the federal securities laws because participants do not invest money in a common enterprise with profits resulting primarily from the efforts of others.

The Ninth Circuit reversed the summary judgment. The court noted that the "central issue is whether Omnitrition's marketing program is a pyramid scheme" and

found that the record contained sufficient evidence to raise a fact question for trial. Relying on its previous holding in the *Glenn Turner* case, the court held that an upper level distributorship (a "supervisor" position) in Omnitrition could be an "investment contract" under the federal securities laws. In so holding, the Ninth Circuit employed the concept of "vertical commonality," which finds in the individual investors' dependency on the efforts of a promoter a "common enterprise."

REASONS FOR GRANTING THE WRIT

A writ of certiorari should be granted in this action for four reasons:

First, the decision by the Ninth Circuit Court of Appeals reflects the continuing split in the Courts of Appeals over whether so called "vertical commonality," the relationship between promoter and investor, creates a "common enterprise" satisfying the requirements of the *Howey* test. The Fifth, Eighth, Ninth and Tenth Circuits accept this concept. The Second, Third, Sixth and Seventh Circuits reject it, and require "horizontal commonality," *i.e.*, that there be shared interests among the numerous investors in a single business enterprise. As a result of this split,[1] the application of the securities laws, including civil and criminal liability for their violation, varies with the selection of a forum by plaintiffs and prosecutors.

Second, the court of appeals' implicit reliance on "vertical commonality" in this case directly contravenes

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[1] This Court recognized this split and almost granted a writ of certiorari in *Mordaunt v. Incomco.*, 469 U.S. 1115 (1985). Since the denial of the writ, the courts of appeals' decisions have widened the split over the type of commonality required under *Howey*, which the Sixth Circuit has labeled a "vexed question." *See Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989).

this Court's requirement of both the "common enterprise" and "efforts of others" elements of the *Howey* test for an investment contract. By substituting the FTC's definition of an "illegal pyramid scheme" for this Court's definition of a "security," the Ninth Circuit Court dismissed the fact that Omnitrition's participants' profits result entirely from their own labors as distributors (or supervising distributors) of Omnitrition products.

Third, this case is vitally important to multi-level companies and their distributors in the United States, a multi-billion dollar industry employing several million participants selling a wide array of products.[2] The decision of the court of appeals jeopardizes the relationship of these companies with their distributors by holding that there could be a sale of a security any time that an individual becomes a "supervisor or distributor" of a multi-level company's products.

Finally, the court of appeals improperly imposed the summary judgment burden of production on Petitioners, movant defendants below, requiring them to show that they do *not* operate an illegal pyramid scheme, rather than requiring plaintiffs to produce evidence that they do. The result conflicts with this Court's holding in *Celotex* and with the intent and purposes of FRCP 56, and creates, in effect, a legal presumption that a multi-level company is an illegal pyramid scheme.

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[2] The *Brief of Amicus Curiae* filed in this appeal by the Direct Selling Association explains that direct selling accounts for approximately $16.5 billion in retail sales in this country annually, 90% of it by its member companies, 70% of which are multi-level companies, which employ more than 6.3 million individuals as direct sellers. *See* Motion of Direct Selling Association for Leave to File Brief *Amicus Curiae* in Support of Petition for Rehearing, and Brief of *Amicus Curiae*, App. 85-115.

THE COURT OF APPEALS' DECISION DEEPENS THE "SPLIT IN THE CIRCUITS" OVER THE "COMMON ENTERPRISE" ELEMENT OF THE *HOWEY* TEST

In this case, the Court of Appeals for the Ninth Circuit reversed a summary judgment for Petitioners in the district court, relying on its eccentric decision in the *Glenn Turner* case, in which it adopted so-called "vertical commonality."[3] This device allows a court to find a

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[3] *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7, *cert. denied*, 414 U.S. 821 (1973) ("a common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or third parties," *quoting Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 175 (9th Cir.), *cert. denied*, 366 U.S. 919, 81 S. Ct. 1095, 6 L.Ed.2d 241 (1961). Additionally, this decision also relaxes the "solely from the efforts of others" element to require only that such efforts are "undeniably significant." *Glenn Turner* at 482.

The court, relying on *Glenn Turner* and the *Koscot* trade case, found Omnitrition presumptively a "pyramid scheme" because of a perceived "recruitment focus." *FTC v. Koscot Interplanetary, Inc.*, 86 FTC 1106 (1975), aff'd sub nom, *Turner v. FTC*, 580 F.2d 701 (D.C. Cir. 1978). The court held that "if Omnitrition's program is a pyramid scheme, investments in the program's supervisor positions are securities," citing *Glenn Turner*. In *Glenn Turner*, an "investor's" profits came as a share of fees paid to the promoter by new recruits brought to "Opportunity Meetings" by the "investor." Because the commissions earned by each "investor" were held to derive from the "undeniably significant efforts" of the scheme's promoters in these recruiting meetings, the court found a "common enterprise" between investor and promoter, thus, "vertical commonality." Because Omnitrition's supervisor-level sales associates earn "royalty overrides" on the sales of their "downlines," the court apprehends a "danger of a recruitment focus" in Omnitrition's structure, which the court finds reminiscent of *Glenn Turner*.

However, Omnitrition pays no fees or commissions for recruiting new participants, so an IMA's earnings do not result

"common enterprise" (and thus an "investment contract") in the "vertical" relationship between an investor and promoter, rather than requiring the "horizontal" relationship among investors in a central business venture contemplated by *Howey*.

"Vertical commonality," rejected so far by the courts of appeals for the Third, Sixth and Seventh Circuits (and at least in its "strict" or "narrow" form, by the Second Circuit), effectively excises the "common enterprise" requirement in favor of an inquiry into whether the success of a venture results "from the 'significant' efforts [or success] of others." This merger of the second and third prongs of the *Howey* test makes the test too inclusive, bringing under coverage of the federal securities laws many arrangements more properly governed by state law, including businesses like that of Omnitrition.

Moreover, what constitutes an "investment contract," and thus a "security," varies now from Circuit to Circuit as the result of the adoption by some of "vertical commonality."[4] This creates great uncertainty for nationwide

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from any efforts by Omnitrition to recruit new IMAs. Profits of an IMA who is a supervisor come only from retail sales and royalty overrides on the orders of "downline" IMAs.

[4] "Vertical commonality" is recognized by the Fifth, Eighth, Ninth, Tenth and Eleventh Circuits. *See, e.g., Hocking v. Dubois*, 839 F.2d 560, 566 (9th Cir. 1988); *McGill v. American Land & Exploration Co.*, 776 F.2d 923, 925-26 (10th Cir. 1985); *Villeneuve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983) (en banc); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 521-22 (5th Cir. 1974); *Miller v. Central Chinchilla Group, Inc.* 494 F.2d 414, 418 (8th Cir. 1974). "Horizontal commonality" is required by the Third, Sixth, and Seventh Circuits. *See, e.g., Wals v. Fox Hills Development Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994); *Hart v. Pulte Homes Corp., Inc.*, 735 F.2d 1001, 1004 (6th Cir. 1984); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3d Cir. 1982). The Second Circuit has rejected "narrow

enterprises (like Omnitrition's), now exacerbated by a holding that suddenly renders numerous legitimate national companies potential violators of the securities laws and "illegal pyramid schemes" in many places.

A. The Real Estate Cases: No Common Enterprise Among Separate Owners Without Horizontal Commonality, but Only in the Second, Sixth and Seventh Circuits.

If this case had come before the Second Circuit, for example, the summary judgment for Petitioners below would have been affirmed. That court has recently rejected "vertical commonality":

> If a common enterprise can be established by the mere showing that the fortunes of investors are tied to the efforts of the promoter, two separate questions posed by *Howey* – whether a common enterprise exists and whether the investors' profits are to be derived solely from the efforts of others – are effectively merged into a single inquiry; "whether the fortuity of the investments collectively is essentially dependent upon promoter expertise."

Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994). The court found the "common enterprise" requirement not "so easily satisfied," *i.e.* by pointing to the same arrangement to show the "efforts of others" and "common enterprise" elements of *Howey*. *Id.* It held the purchase-and-lease transactions between a number of condominium buyers and a developer are not securities because there was no enterprise in common among the investors: "Plaintiffs owned individual units and could make profits

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vertical commonality" on reasoning that would seem to include "broad vertical commonality," as well. *See Revak v. SEC Realty Corp.*, 18 F.3d 81, 87-88 (2d Cir. 1994).

or sustain losses independent of the fortunes of the other purchasers." *Id.*

The Fifth Circuit, by contrast, might well have found an investment contract in this case, as well as in *Revak*.[5] Although the *Revak* plaintiffs bought separable interests, they bought them in a condominium development, and the success of the individual investments could arguably have been said to have depended on "promoter expertise" in developing and marketing the entire development. *Compare, e.g., Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 192 (5th Cir. 1979); *SEC v. Koscot Interplanetary*, 497 F.2d 473, 479 (5th Cir. 1974). Unfortunately, such reasoning would render the sale of a house in virtually any real estate development "security," if it can be shown that the appreciation of such property was "inextricably tied to the efficacy" of the developer. The Second Circuit is correct in requiring that different facts support each of the *Howey* elements: otherwise, the "common enterprise" element disappears and transactions, such as contracts for the sale of real property, become "securities" when an appreciation in value results from some act or circumstance in the control of another.

The Seventh Circuit also rejects "vertical commonality" as inconsistent with *Howey* and the securities laws:

> The statutory language ("the term 'security' means any note, stock, treasury stock, bond, debenture, investment contract . . . or, in general, any interest or instrument commonly known as a 'security',") . . . suggests that the term "investment contract" has the limited purpose of identifying unconventional instruments *that have the essential properties of a debt or equity*

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[5] *See, e.g., SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974) ("requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy" of promoters).

> *security . . . A share of stock, for example, is an undivided interest in an enterprise, entitling the owner to a pro-rata share in the enterprise's profits . . . The owner of a condominium does not own an undivided share of the building complex in which his condominium is located.*

Wals v. Fox Hills Development Corp., 24 F.3d 1016, 1018 (7th Cir. 1994) (citations omitted) (emphasis added). The court requires "horizontal commonality":

> . . . a pooling of interests not only between the developer and promoter and each individual 'investor,' but also among the 'investors' (the owners of the condominiums, in this case) – we require, in short, a wheel and not just a hub and a spoke.

Id. Judge Posner also noted that the securities laws are disclosure statutes; uniform disclosures to all investors are possible only if the investors are buying the same interests. *See also, Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989) (emphasis added), *citing Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir. 1972) (there must be a pooling of funds among two or more investors); and *Hart v. Pulte Homes Corp., Inc.*, 735 F.2d 1001, 1004 (6th Cir. 1984) (new houses sold by a developer are not investment contracts, even though offered for purchase as investments and leased back by developer as model homes).

In *Hart*, the developer promised tax benefits, capital appreciation and rental income. Each buyer arguably depended on "promoter expertise" for appreciation in value, creating a "vertical commonality" between the developers and the buyers. Yet, the court held there was no common enterprise:

> [t]he mere fact that an assurance of development may have come from the same seller does not satisfy the requirement of horizontal commonality.

In fact, *Hart* shows how reliance upon "vertical commonality" signals the *absence* of a central venture capitalized by investors funds, and thus, the absence of a *Howey*-type "common enterprise."

B. The Brokerage Account Cases: No Common Enterprise Among Separate Brokerage Accounts, Despite Management by the Same Broker, in the Third, Sixth and Seventh Circuits, but a Single Account Is a "Common Enterprise" in the Ninth Circuit and Separate Accounts Are a "Common Enterprise" in the Fifth Circuit.

That the relationships creating "vertical commonality" do not create a "security" is also shown by its application in the cases concerning discretionary brokerage accounts. In "strict" or vertical commonality, an investor's success must be tied to the *success* of the promoter, not merely his "efforts." *See, e.g., Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978) (discretionary brokerage account not a security when broker is paid a flat fee). The fact that the promoter stands the same risk as the investor theoretically renders his relationship with the investor an enterprise "in common" between them. This logic would apply the securities laws to an "enterprise" consisting of one investor and one broker, but *only* if the broker is not paid a flat fee for his management of the investor's money.[6] This is not a "common enterprise" as *Howey* requires it.

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[6] This reasoning does not serve the purpose of the securities laws, which is investor protection through disclosure. The result in the *Brodt* case demonstrates as much: a broker's incentive under a flat-fee-per-trade agreement is to "churn" the account, regardless of the success of the trades, increasing, not diminishing, the need for full disclosure to protect the investor. *See, e.g.*, James Gordon, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 Colum. Bus. L. Rev. 635, 649.

The Fifth Circuit has held discretionary brokerage accounts investment contracts on reasoning unique to that court. *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974). Rejecting the "horizontal" approach of the Seventh Circuit, the court said:

> . . . the critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts.

Id. at 523. The *Continental Commodities* plaintiffs were the owners of separate accounts traded by defendants, and there was no pooling of funds or profits. The court, nevertheless, held that:

> . . . the critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise . . . . That it may bear more productive fruit in the case of some options than it does in others should not vitiate the fact that the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities.

Id. This logic of the Fifth Circuit is not persuasive. The *Continental Commodities* investors are not "collected" by their investment of money in a venture common to them all any more than, say, the separate clients of an attorney are "collectively dependent" on his expertise.[7]

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[7] *But see, Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989). *Long* seems to incline toward horizontal commonality because the holding rests neither upon "vertical" nor "horizontal" commonality, but on the fact that, as in *Howey*, all of the investors were fundamentally dependent on the existence of a larger enterprise, a cattle-feeding venture, in which they all participated, as well as on the "essential managerial efforts" that made its operation possible. In short, the single feedlot in *Long* is a "common enterprise" in precisely the *Howey* sense, and

This is the very point made by the *Milnarik* case, in which then-Judge Stevens quoted at length the lucid discussion of the district court in rejecting vertical commonality in the context of a brokerage account:

> In essence, this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise. *No matter how many different persons Nelson became the agent for under similar or even identical discretionary contracts, his relationship with each would remain as that of agent and principal.* Each contract creating this relationship is unitary in nature and each will be a success or failure without regard to the others. Some may show a profit, some a loss, but they are independent of each . . . .
>
> . . . . [the] characteristic of common enterprise is completely lacking in the present case. . . . No claim is made that Nelson traded in a uniform manner for each of these accounts. Even if he had so uniformly traded, not pooling of funds for a common purpose is alleged . . . . The plaintiffs in no way can be viewed as having invested in a common enterprise with other suppliers of venture capital.

Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 278 (emphasis added).

The Sixth Circuit has followed *Milnarik* in these cases. *Curran v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980). That court has also held that "vertical commonality is inconsistent with *Howey* because it excises the common enterprise requirements and finds a security in the "entrustment by a single principle of money to an agent." *Id., quoting Berman v. Bache, Halsey, Stuart, Shields, Inc.*, 467 F. Supp. 311, 315-16 (S.D. Ohio (1979) (emphasis added). The Third Circuit

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the separate brokerage accounts in *Continental Commodities* are not.

also follows this approach, in *Salcer v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3d Cir. 1982) and requires a horizontal relation among investors.

C. The Instant Case: A "Common Enterprise" Created by a Mere "Recruitment Focus" Is "Vertical Commonality" Ad Absurdum.

In the instant case, the Ninth Circuit has dispensed with the most critical feature of the *Howey* test. The misconception of the court of appeals is that the "recruitment focus it perceived in the multi-level structure creates the requisite "vertical commonality," i.e., that each participant depends on the recruitment efforts of the company, as in *Glenn Turner.* But even in *Glenn Turner,* while the promoters' efforts were held to be, in effect, the "enterprise" in which a participant invested, no participant there held "a *unit*" or share of the *same* enterprise in which any of the other participants invested. Each might have "invested" in the promoter's "efforts," but, like the account-holders in *Milnarik,* each did it separately, and *Howey* requires a "common enterprise."

In the instant case, the *Glenn Turner* reasoning is disastrous: here, independent sales associates, linked only by the fact that they sell the same line of products, are implicitly held to have a "vertical commonality" with the company from which they buy the products. But there is absolutely *no* "common enterprise" among them and, thus, no "security." Viewed in the light of the reasoned decisions of the Second, Third, Sixth and Seventh Circuits (and even of the Fifth, in *Long*), the result reached in this case by the Ninth Circuit is capricious.[8] The concept of "vertical commonality," in *Glenn Turner,* is little more

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[8] In fact, even under *Glenn Turner* principles, there is no "common enterprise" between an Omnitrition supervisor and the company, because his success depends overwhelmingly on his own efforts in selling Omnitrition products and supervising other IMAs.

than an expedient device for addressing a pernicious scheme and has caused that court to stray far from *Howey* principles.

The existence *vel non* of a security should not depend upon the choice of a federal forum: it should be based upon the consistent application of the same principles in all federal courts. These principles have been well-articulated in previous decisions of this Court, as shown below, and merely require confirmation in a rejection now of "vertical commonality" to the extent it conflicts, as in the present case, with this Court's precedents.

THE NINTH CIRCUIT'S DECISION IS IN DIRECT CONFLICT WITH SUPREME COURT PRECEDENTS CONCERNING THE DEFINITION OF AN INVESTMENT CONTRACT

A. The Ninth Circuit Conflicts with *Howey* in this Case, as a Result of Its New Test for a "Security."

The result in this case could not have been reached without the Ninth Circuit's transformation of the *Howey* test. A court applying the concepts articulated in *Howey*, correspondingly, could not find a "security" in an individual's participation as a sales associate in a multi-level products-distribution organization, as the Ninth Circuit Court did here. Multi-level companies do not engage in the sale of securities, as *Howey* defines them, and as commonly conceived. No participant in a multi-level distribution network buys a share of the enterprise or its earnings. MLMs typically require no investment of money, beyond an initial investment in products for resale (typically, as here, returnable), at discounts varying with their volume. The earnings of the IMAs in such a program are economically the functional equivalent of sales commissions.

The Ninth Circuit first determined that a multi-level marketing company sold securities in its consideration of

a very different kind of enterprise. In its *Glenn Turner* case, it found that a participation in a "pyramid scheme" was a security, because profits depended on the efforts of the scheme promoter in recruiting new participants.

Neither the reasoning nor the result of *Glenn Turner*, particularly, as it is applied here, consists with *Howey*. The fact that the investment at issue in *Howey* looked like a stake in the success of the entire orange grove drove that holding. The importance of *Howey* is that the basic requirement for a security, at a minimum, is that an investor's money purchases a share of the profits of a business enterprise for which, with others, he provides the capital. The radically-revised Ninth Circuit test[9] for a security flies in the face of *Howey* principles.

Beginning with the *Joiner* case, this Court has steadfastly adhered to the *Howey* concept of a "common enterprise." *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). In *Joiner*, this Court found an investment contract in transactions coupling the sale of tracts of land with assignments of oil leases, which proposed through these sales to finance the drilling of oil; if the drilling was successful, profits were to be shared *pro rata* among the lease-holders. The Court's reasoning shows that the controlling consideration is that the investors all shared in a single enterprise:

> Their proposition was to sell documents which offered the purchasers a chance, without undue delay or additional cost, of sharing in discovery values which might follow a current exploration enterprise. The drilling of this well was not an unconnected or uncontrolled phenomenon to which salesmen pointed merely to show the

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[9] *See* notes 2, 3 *above*, for discussion of the alteration of the *Howey* test by the Ninth Circuit's definition of a "common enterprise" and by its relaxation of the "solely from the efforts of others" requirement.

> possibility of the offered leases. The exploration enterprise was woven into the leaseholds, both in an economic and a legal sense; the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung.

Id., 320 U.S. at 348. The profits of this venture would be a classic example of "captial appreciation," and would result from the "enterprise" – the drilling for oil – financed by the investors. Thus, the Court held that the well-drilling undertaking gave the interests sold "most of their value and all of their lure." *Id.* at 348.

In *Joiner,* the Court could have rested on vertical commonality: the success of each investment depended on the efforts of the promoters in finding oil. Rather, the Court examined the manner in which the investment was offered and distributed, the characterization of the profits to be earned, that the investors expected rewards on a *pro rata* basis, and that there was a pure use of the investors' funds to capitalize the enterprise: these were the factors that made the investment a "security." *Id.* at 352-53.

The overarching concern of the Court in *Joiner* was the identification of the interest that Congress sought to protect – the honesty of the capital markets. *Id.* Since the prototypical "security" is stock in a corporation, the Court has sought resemblances in the arrangements brought before it to that paradigm. Thus, when the *Howey* case came up, the Court sought to isolate those qualities that made the arrangement similar to the issuance of shares in a corporation's stock: that it was a stake in the profits of a business venture, and that it represented a value apart from that of the nominal interest in particular citrus trees. *Howey,* 328 U.S. at 299. The profits anticipated were functionally a participation in those of the entire grove, and a return to the money supplied by the investors to finance the enterprise as a whole. *Id.*

The "common enterprise" in *Howey* depended not on each investor's relationship to the enterprise, but on the fact that there *was* an enterprise common to them all, without which there could be no profits for any of the investors, a fact understood by the purchasers of the offered interests:

> The respondent companies . . . are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise . . . [a]ll the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise.

SEC v. Howey, 328 U.S. at 299.

When the courts find that a "vertical commonality" satisfies the "common enterprise" requirement – that is, that there need be no "enterprise" apart from the relationship of the investor to the promoter – they excise from the concept of a "security" a critical factor: the economic arrangement and function distinguishing a mere partnership, agency or joint venture from an interest appropriately brought under the peculiar protections of the securities laws.[10]

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[10] Such courts overlook another, perhaps too obvious, consideration: there are numerous examples in the common and statutory law of relationships in which money can be made through the "efforts of others." Congress, in enacting the Securities Act of 1933 and the Securities Exchange Act of 1934 surely did not mean merely to duplicate or even enhance existing causes of action arising from this variety of "vertical" relationships already recognized in state laws, such as fraud, breach of fiduciary duties, and breach of contract actions. The definition of a "security" must contemplate something more. *See, e.g., Marine Bank v. Weaver*, 455 U.S. 551-556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.")

Joiner and *Howey* established foundational principles. These concepts do not revolve around the dependence of investor upon promoter, for numerous legal principles and the laws arising from them already protect such reliance interests.[11] Instead, both *Joiner* and *Howey* stress the way in which profits are made from the use of money put into an enterprise – *"a profit-seeking business venture . . . [in which] the investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise"* – as the essence of a "security." *Howey*, 328 U.S. at 300.

B. This Court's Decisions Following *Howey* and *Joiner* Require a Horizontal "Common Enterprise," and Are Inconsistent with "Vertical Commonality."

While the Ninth Circuit dispenses with the "enterprise" of *Howey* and *Joiner*, later Supreme Court cases confirm these concepts. In *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65 (1959), the Court could have found either vertical or horizontal commonality, but based its holding simply on the fact that the investment, a "variable annuity contract," paid profits resulting from an investment pool, analogous to a mutual fund, unambiguously a security. *Id.* 69, 72 n. 13, 73 n. 4, 91 (Brennan, J. concurring).

In *Tcherepnin v. Knight* the Court also bypassed a chance to define a security in terms of the relationships

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[11] It is telling that the decision that ostensibly provides a major source of support for the Ninth Circuit's holding in this case is an FTC proceeding, filed under the Federal Trade Act, not the federal securities laws. *FTC v. Koscot Interplanetary, Inc.*, 86 FTC 1106 (1975), aff'd sub nom., *Turner v. FTC*, 580 F.2d 701 (D.C. Cir. 1978). Respondents' Complaint below includes a great array of other federal and state claims.

between investors and promoters. 389 U.S. 332 (1967). Instead, the Court focused on the fact that the profits expected from the "withdrawable capital shares" in a savings and loan association reflected a share of the issuers' profits. To the *Tcherepnin* Court, this arrangement, as a matter of "economic reality," was a classic security in which profits resulted from an investment in the operations of a business venture managed by others, a participation in its earnings, like common stock. *Id.* at 337-39.

In *SEC v. United Benefit Life Insurance Company,* the Court made a significant distinction between profits issuing from a "variable annuity contract" and those resulting from an ordinary annuity. 387 U.S. 202, 207-08 (1967) in a "variable annuity contract," the risks and rewards of an annuity contract were "pooled" among the program's participants, whereas in a conventional annuity, fixed amounts of benefits are established for each contract and the insurer calculates what premiums will cover the ultimate benefits and expenses. In the variable annuity at issue in *United Benefit Life,* the policy holders *collectively* bore the risks of such calculation: the "Flexible Funds" investment program was a "common enterprise" among them from which the anticipated profits would flow. *Id.* at 208.

Moreover, the Court's distinction eliminates "vertical commonality" as the controlling principle: broad vertical commonality is present in a conventional annuity program, yet it is, by implication, held *not* a security. Only the fact that risks and rewards were pooled by investors in a distinct enterprise, among the company's other programs, led the Court to find an investment contract in the Flexible Funds program, and only in that one. *Id.* at 205.

Perhaps the most obvious opportunity for this Court to find an investment a "security" based on vertical commonality was in *Marine Bank v. Weaver,* 455 U.S. 551 (1982). The case involved a profit-sharing agreement between the owner of a meat-packing business and

Waver, who guaranteed a bank loan to the company in exchange for a share of its profits: this was plainly, a case of "vertical commonality." Yet, this Court found no security in the transaction, based on the fact that the agreement was a privately-negotiated transaction, and lacked money of the indicia of securities that brought them within Congress' purview in the Securities Acts. *Weaver* confirms the *Howey* concept of a common enterprise: that a "security" is ideally a uniform, undivided interest held with others in a central profit-seeking venture.

These cases together show than an "investment contract" or, indeed, a "security," requires more than "vertical commonality." An investment of money becomes a security only when it is part of an enterprise held in common with other investors and in uniform shares amendable to and needful of uniform disclosures.

C. The Ninth Circuit Ignored the Basic Principles Underlying this Court's Precedents in Discarding the "Common Enterprise" Requirement in this Case.

Compared to the interests sold in *Howey, Joiner, Tcherepnin* and *United Benefit Life,* and analyzed against the principles employed in deciding those cases, Omnitrition distributorships are not securities. An Omnitrition supervisor cannot participate in the profits of the entire enterprise, as in *Howey* or *Tcherepnin,* and he does not make a capital investment in a central enterprise that will result in profits from appreciation of property values, as in *Joiner.* There is no "pool" of funds from which an Omnitrition IMA might expect a return from his investment, as in *United Benefit Life.* An IMA has not acquired a uniform or tradable interest.

This Court has applied the basic concepts reflected in the decisions discussed above most recently to securities cases not involving investment contacts. *Reves v. Ernst &*

Young, 494 U.S. 55, 66-67 (1990). In *Reves*, the Court distinguished between notes that are securities and those that are not. The Court articulated "the same basic factors that this Court has held apply in deciding whether a transaction involves a 'security'." *Id.* at 66.

Those factors that distinguish a note that is a "security" from one that is not are:

1) whether there is a purpose to raise capital on the part of the seller and to make a profit in the form of interest on the part of the buyer;
2) whether there is "common trading" in the instrument;
3) whether there is a reasonable expectation by investors that the instrument is covered by the securities laws; and
4) whether any other regulatory scheme reduces the risk to the investor.

Id. at 66-67. These are, in fact, the principles that have clarified the Court's decisions as to an "investment contract", and are the most important principles underlying the concept of a "security."

Examined against these principles, an MLM distributorship cannot be a security: it is not sold to raise capital, it is not and cannot be commonly traded, it cannot reasonably be expected to be regulated by the securities laws, and the plethora of state and federal law causes of action included in Respondents' class-action Complaint below show that there are adequate remedies available for supervisors injured by participating in an MLM.

The most important securities-law principles articulated by this Court are thus inconsistent with the use of "vertical commonality" to find a security in an MLM distributorship in this case. The Court should grant the writ to affirm and strengthen these principles, and to correct the inconsistent application of the securities laws among the Circuit Courts of Appeals.

THE COURT OF APPEALS IMPROPERLY IMPOSED THE SUMMARY JUDGMENT BURDEN OF PRODUCTION UPON PETITIONERS AS DEFENDANT-MOVANTS, CONTRARY TO THE *CELOTEX* HOLDING

A very large part of the problem with the Court of Appeals' holdings in this case results from its error in allocating the burdens of proof on summary judgment. The court requires that Omnitrition, as a defendant movant, produce evidence proving that it is *not* an illegal pyramid scheme, rather than requiring Plaintiffs to produce evidence that it *is*. The effect of this holding, coupled with the court's holdings on the substantive legal issues, is to create a legal presumption that a multi-level company is an illegal pyramid scheme.

The correct allocation of the burdens of proof on summary judgment have been set forth by this Court in the *Celotex* case:

> Rule 56 mandates the entry of summary judgment . . . against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which the party will bear the burden of proof at trial.

Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). Under *Celotex*, Omnitrition properly had only " . . . the initial burden of informing the district court of the basis for its motion." *Id.* at 323. That burden "may be discharged by showing – that is, pointing out to the district court – that there is an absence of evidence to support the nonmoving party's case." *Id.* at 325.

Accordingly, Omnitrition had no burden to produce any evidence on summary judgment. Nevertheless, the Court of Appeals reversed the district court's summary judgment for Petitioners because they did *not* prove that Omnitrition does not operate a pyramid scheme. For

example, the Ninth Circuit dismissed evidence of Omnitrition's anti-pyramiding safeguards by declaring that it was Omnitrition's burden to establish that those safeguards worked – rather than the Plaintiffs' burden to establish that they did not.

Plaintiffs' burden was to produce evidence of material facts in dispute on each element of their claims. That means, in this case, that they must adduce some evidence of facts in dispute on each element of their pyramiding claims, on each element of their securities law claims (on which their RICO claim depends), and on each element of their state law claims. The district court held that Plaintiffs had not produced competent or credible evidence on all of the essential elements of any of these claims.

Where the Court of Appeals went wrong was in their initial analysis of the pyramid claim. The court adopted the substantive legal analysis articulated in the FTC *Koscot* case, with which Petitioners do not quarrel. *FTC v. Koscot Interplanetary, Inc.*, 86 FTC 1106, 1181 (1975), *aff'd mem. sub nom., Turner v. FTC*, 580 F.2d 701 (D.C. Cir. 1978). *Koscot* sets forth a test for identifying "pyramid schemes" that offend the antifraud provisions of the trade-regulation laws. Under *Koscot*, an illegal pyramid scheme is one that:

(1) requires the payment of a fee for the right to sell a product; and

(2) offers rewards for recruiting others into the program that are unrelated to the sale of products to the ultimate consumer.

Koscot, 86 FTC at 1181. Thus, Plaintiffs in this case properly had the burden to produce evidence sufficient to establish a triable fact issue on both of the above elements.

In its Motion for Summary Judgment, Omnitrition proved that it does not require a fee for the right to sell a product, and that it does not offer any rewards for recruiting others into the program. In addition, it proved

that its program includes certain anti-pyramiding procedures, established under the guidance of existing law to ensure that no recruiting rewards are paid except as they are related to products sales, and to prevent "inventory loading" which might tend to make product purchases the equivalent of a payment for the right to sell Omnitrition products or to recruit others.

These procedures are known as the "Amway safeguards," after the seminal FTC case which held that these procedures distinguish legitimate multi-level sales operation from pyramid schemes. *In re Amway Corp.*, 93 FTC 618 (1979). According to *Amway*, an MLM is not an illegal pyramid if:

(1) it will buy back unsold merchandise;

(2) participants are required to sell the greater part of their products before reordering; and

(3) participants provide proof of retail sales.

These procedures assure the relationship between "recruitment rewards" and retail sales, and that product sales is the main business of a multi-level company. The *Amway* case, thus, established that there is nothing per se unlawful about multi-level sales organizations, nor any legal reason that multi-level companies ought to be presumed to be pyramid schemes.

The Court of Appeals, however, has effectively imposed such a presumption in holding that Omnitrition must produce evidence that the *Amway* safeguards actually work. The Court shifted the burden of production to Petitioners by holding that:

> Where, as here, a distribution program *appears* to meet the Koscot definition of a pyramid scheme, *there must be evidence that the program's safeguards are enforced and actually serve to deter inventory loading and encourage retail sales.*

Webster, 79 F.3d at 2035-2036 (emphasis added). In so holding, the court precisely reversed the proper Rule 56 burden of proof.

To prevail at trial, Plaintiffs must prove that the two *Koscot* factors are present in Omnitrition's program. On summary judgment, therefore, Plaintiffs as non-movants must produce some evidence of each of the *Koscot* elements. Evidence of the Amway safeguards in place would demonstrate that the *Koscot* elements are *not* present in Omnitrition's program. In reversing summary judgment for Omnitrition, and in burdening Omnitrition to produce evidence that the Amway safeguards actually work, rather than requiring Plaintiffs to show that they do *not*, the Court turns *Celotex* completely on its head.[12]

Reverting back to the old summary judgment rule of *Adickes v. Kress*, 398 U.S. 144, 157 (1970), the Court of Appeals reversed Omnitrition's summary judgment on the grounds that it, a defendant-movant, must foreclose that Plaintiffs *could* prevail at trial. *Adickes* has, of course, been overruled by the *Celotex* case, but the Court of Appeals, nonetheless, held that Omnitrition bore the burden of production on three critical issues:

> First, Omnitrition produced evidence of enforcement only for its ten customer rule. . . . That some amount of product was sold by each supervisor to only ten customers each month

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[12] Omnitrition has suffered for exceeding its summary judgment burden of production. In pointing in its Motion to the evidence that its program is modeled on the FTC-approved *Amway* structure, Omnitrition shifted the burden to Plaintiffs to produce evidence that the *Koscot* elements are met despite the Amway safeguards in place, or that the Amway safeguards do not serve to assure against the *Koscot* elements. But Omnitrition's summary judgment proof – and the district court's holding that Omnitrition did show that the safeguards "work" – does not relieve Plaintiffs of their burden to produce evidence of the *Koscot* elements.

> does not insure that overrides are being paid as a result of actual retail sales.
>
> Second, Omnitrition produced no evidence of enforcement of its 70% rule. . . . There is no evidence that this "certification" requirement actually serves to deter inventory loading. . . .

Webster, 79 F.3d at 2036-2037. As a consequence of this error in allocating the burden, the Court ruled that: "Our review of the record does not reveal sufficient evidence to establish as a matter of law that Omnitrition's rules *actually work.*" *Id.* at 2036 (emphasis added). This is wrong: under *Celotex*, the plaintiff-nonmovants have the burden to produce evidence that these anti-pyramiding rules *do not work.*

The Court of Appeals' error as to the Rule 56 burden relative to the *Koscot* factors led it astray on the securities law and RICO claims. As the upshot of its discussion of the *Koscot* test, it holds that "[i]f Omnitrition's program is a pyramid scheme, investments in the program's supervisor positions are securities."

The court's Opinion included no discussion or analysis of the fact that there is no evidence of any "investment" required to participate in Omnitrition, or that there is no evidence that there is a "common enterprise," *despite* that the question before it was whether Plaintiffs had produced any evidence of any of the elements of a "security." The court thus builds upon its erroneous ruling that Omnitrition had failed to produce evidence that it is not an illegal pyramid scheme under *Koscot*, to establish that there is a triable issue as to the securities claims. "By the very structure of a pyramid scheme," the court implacably holds, "participants' efforts are focused not on selling products but on recruiting others to join the scheme." But it had established that there *is* a "pyramid scheme" only through its holding in error that Omnitrition had not proved that it is *not* a pyramid scheme!

Likewise, the court holds that there is a triable issue of fact on whether Omnitrition's statements describing its program are false for purposes of §12(2) and Rule 10b-5. As to these, the court holds:

> Pyramid schemes are destined to collapse, and the most recent entrants to lose their money. This fact would always be present to undermine the truth of promotional statements.

Id. at 2040. But it has only erroneously determined that there is any evidence that there is a "pyramid scheme." Had the court properly placed the burden upon the Plaintiffs to produce evidence that Omnitrition is a pyramid scheme, the court would have had to affirm the district court's summary judgment on the securities law claims, as well.

The same is true as to the court's holding as the Plaintiffs' RICO claims, because the court holds that,

> because there is a triable issue of fact as to whether Omnitrition was operating an inherently fraudulent pyramid scheme, there also is a triable issue of fact as to whether Omnitrition's promotion of the scheme and use of the mails and wires in furthering the scheme constituted securities fraud, mail fraud and wire fraud respectively. All of these are predicate acts sufficient to allow plaintiffs to invoke Civil RICO.

Id. at 2042. But, there was no "triable issue of fact as to whether Petitioner was operating an inherently fraudulent scheme" under a correct application of Rule 56. There is thus no "triable issue" as to RICO, either.

Finally, the court also tacks on to its faulty holding as to the *Koscot* test, a holding that there is an identical triable issue as to plaintiffs' claims under California's "Endless Chain" law. Cal. Penal Code §327 (West 1995). Thus:

> Because there is sufficient evidence for a jury to conclude the Omnitrition program fails the

> *Koscot* test, there also is a genuine issue of material fact as to whether it is an "endless chain" scheme under §327.

Id. at 2045. The holding also encompasses Plaintiffs' similarly dependent claims for common law fraud, as to which the Court holds that "the existence of a triable issue of fact as to Omnitrition's operation of a pyramid scheme raises triable issues of fact as to [Plaintiffs'] cause of action for common law fraud." *Id.* at 2046. The entire decision is erroneous due to the court's initial error in misallocating the plaintiffs' burden of production.

The error imposes upon a multi-level marketing company, a defendant-movant for summary judgment in this case, the burden to produce evidence that it is not an illegal pyramid scheme. The effect of such a holding by one of the United States Courts of Appeals is to subject to expensive and protracted trials the many thriving and legitimate companies who distribute their products through multi-level organizations. In short, the court has, perhaps unwittingly, established a presumption of illegality against all multi-level companies, which could force a company to trial merely by brandishing the company's brochure. Companies like Beauti-Control, Mary Kay Cosmetics, Excel and HerbaLife, successful and durable companies all, and many others, are made ready targets of "strike suits."

The effect of the *Celotex* case and its progeny has been to resolve cases on summary judgment when plaintiffs cannot prove that there are sufficient disputed fact issues to warrant the enormous expense to the courts and to defendants of litigating their claims through a full trial. But the efficacy of this principle depends upon the proper allocation of the burdens of proof in judging motions for summary judgment. The District Court in this case faithfully followed the *Celotex rules;* the Court of Appeals did not. The burden of district courts will unquestionably increase, and the expense to legitimate companies will

likely explode, as a result. This Court should therefore grant this Petition, and review and reverse the Court of Appeals' ill-conceived holding.

CONCLUSION AND PRAYER

For the foregoing reasons, this Court should grant a writ of certiorari to resolve the split among the Circuit Courts of Appeals regarding the use of "vertical commonality" to satisfy the "common enterprise" requirement for an investment contract, and to review the Ninth Circuit's error in allocating the Rule 56 burden of production.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

SHAUN WEBSTER and ROBERT LIGON, *Plaintiffs-Appellants,* v. OMNITRITION INTERNATIONAL, INC.; JIM FOBAIR; ROGER DALEY; CHARLES RAGUS; and JERRY RUBIN, *Defendants-Appellees.*	No. 94-16477 D.C. No. CV-92-04133-SBA
SHAUN WEBSTER and ROBERT LIGON, *Plaintiffs-Appellants,* v. DOUGLAS ADKINS; and GARDERE & WYNNE, *Defendants-Appellees.*	No. 94-164478 D.C. No. CV-92-04133-SBA OPINION

Appeal from the United States District Court
for the Northern District of California
Saundra B. Armstrong, District Judge, Presiding

Argued and Submitted
September 12, 1995 – San Francisco, California

Filed March 4, 1996

Before: Herbert Y.C. Choy, Robert R. Beezer and David R. Thompson, Circuit Judges.

Opinion by Judge Beezer

COUNSEL

Richard M. Heimann and Karen E. Karpen, Lieff, Cabraser & Heimann, San Francisco, California, for the plaintiffs-appellants.

William Christopher Carmody, Dallas, Texas; Robert T. Sullwold, Orrick, Herrington & Sutcliffe, San Francisco, California; Edward King, San Francisco, California, for the defendants-appellees.

OPINION

BEEZER, Circuit Judge:

We consider what constitutes an inherently fraudulent pyramid scheme for purposes of several federal antifraud statutes.

Shaun Webster and Robert Ligon represent a class of participants (collectively "Webster") in a "multi level marketing" program promoted by Omnitrition International, Inc. ("Omnitrition"). Webster alleges that Omnitrition, Roger Daley, Charles Ragus, James Fobair and Jerry Rubin operated an inherently fraudulent pyramid scheme under both California and federal law. Webster amended the complaint to add as defendants Omnitrition's outside counsel, Douglas Adkins, and his law firm, Gardere & Wynne, L.L.P. (collectively "Attorney Defendants").

The district court granted summary judgment in favor of all defendants, holding that Omnitrition's program was not a pyramid scheme as a matter of law. The court also held that the federal securities claims against

Attorney Defendants were barred by the statute of limitations.

Webster appeals, claiming that there are disputed issues of material fact as well as errors of law. We have jurisdiction and we affirm in part and reverse in part.

I

Omnitrition is a corporation which operates a "multi level marketing" program, selling nutritional supplements, vitamins and skin care products. Members of Omnitrition's retail sales force are known as "Independent Marketing Associates" ("IMAs").

The first level of IMAs are referred to by Omnitrition as "distributors." There is no charge to become a distributor, and distributors have no quota of products they must purchase or sell. A distributor has the right to buy products at a discount from Omnitrition for use or resale and to recruit others into the program. A distributor can qualify to become a "Bronze Supervisor" by *ordering* a minimum amount (several thousand dollars) in products, measured by suggested retail price, from Omnitrition in one or two (consecutive) months.[1] In order to remain a supervisor, an IMA must continue to meet the minimum order requirements each month.

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[1] Somewhat cryptically, Omnitrition refers to the amount of products one of its salespeople orders in a month as "Sales Volume." This figure does not represent the amount of products a salesperson has *sold* at retail, however. It is arrived at by calculating the suggested retail price of products the salesperson *bought* at wholesale from Omnitrition.

Bronze Supervisors are entitled to receive a "Royalty Override Bonus" on up to three generations of "downline" supervisors, i.e. people the supervisor recruits who themselves also meet the minimum monthly order requirements to be supervisors. The "Royalty Override Bonus" gives the Bronze Supervisor a 1 to 4% commission on orders placed by downline supervisors. Supervisors and those they recruit must continue to purchase a minimum amount of products each month from Omnitrition to qualify the supervisor for commissions. Beyond the Bronze Supervisor level are Silver, Gold, and Diamond supervisors, who can recruit more supervisors into the program and earn the right to royalties on up to six levels of downline supervisors.

Omnitrition has three policies which are supposed to encourage retail sales. First, to order products, IMAs must certify that they have sold at least 70% of products previously purchased. This requirement can be met either by retail sales to end users or by sales to downline IMAs. Second, to qualify to earn commissions on downline orders, supervisors must certify that they have made sales to ten retail customers in the past month. It is undisputed that Omnitrition randomly calls some customers listed by supervisors to confirm that the sales have occurred. Third, if an IMA resigns from the program, Omnitrition will buy back unsold inventory for 90% of invoice price, with the caveat that Omnitrition will only repurchase consumable products that are less than three months old.

Fobair, Daley and Ragus are corporate officers of Omnitrition. Rubin, now deceased but appearing by the executor of his estate, was alleged to be involved in the

creation and promotion of the marketing program. Adkins, a partner at Gardere & Wynne, is outside counsel and Assistant Secretary of Omnitrition. Adkins appears in a promotional videotape produced by Omnitrition, in which he states that Omnitrition is "not a pyramid scheme," gives advice on how to sell the nutritional products within the constraints of FDA guidelines, and makes other promotional statements concerning Omnitrition.

Webster and Ligon are former Omnitrition IMAs. Each filed class actions, Ligon in the Southern District of Texas and Webster in the Northern District of California, on behalf of all IMAs in Omnitrition's program who lost money. The two actions were consolidated in the Northern District of California and the district court certified the class. Webster's amended complaint alleges that Omnitrition's marketing program is actually a fraudulent pyramid scheme violative of federal securities laws, state unfair sales practice and fraud laws and the Racketeer Influenced and Corrupt Organizations Act ("RICO") (18 U.S.C. § 1961 *et seq.*).

The district court granted summary judgment for all defendants on the ground that Webster had failed to raise a triable issue of fact as to whether Omnitrition's program was a pyramid scheme; the district court held that Omnitrition's policies designed to encourage retail sales took the program outside the definition of fraudulent pyramid schemes. Most of the remainder of the district court's reasons for granting summary judgment depend on this determination.

The district court determined that Omnitrition distributorships were not securities within the purview of

the federal securities laws because their return did not depend primarily on the efforts of others. The district court further held that, because the program was not fraudulent, its operation and promotion did not constitute predicate acts under RICO. Finally, the district court determined that Webster had failed to provide evidence of several elements of the state law claims.

The district court granted summary judgment to the Attorney Defendants holding that the limitation period of the statute of limitations had expired on the federal securities claims. Webster timely appeals.

II

We review a grant of summary judgment *de novo*. *Atwood v. Newmont Gold Co.*, 45 F.3d 1317, 1320 (9th Cir. 1995). We determine whether the district court correctly applied the relevant substantive law and, viewing the evidence in the light most favorable to the nonmoving party, whether there are genuine issues of material fact. *Jesinger v. Nevada Federal Credit Union*, 24 F.3d 1127, 1130 (9th Cir. 1994).

The central issue is whether Omnitrition's marketing program is a pyramid scheme. Operation of a pyramid scheme constitutes fraud for purposes of § 12(2) of the Securities Act of 1933, § 10 of the Securities Exchange Act of 1934 and various RICO predicate acts. Because the record contains sufficient evidence to present a genuine issue of disputed material fact as to whether Omnitrition promotes a pyramid scheme, we reverse the grant of summary judgment.

A.

Pyramid schemes are said to be inherently fraudulent because they must eventually collapse. *See, e.g., S.E.C. v. International Loan Network, Inc.*, 968 F.2d 1304, 1309 (D.C. Cir. 1992). Like chain letters, pyramid schemes may make money for those at the top of the chain or pyramid, but "must end up disappointing those at the bottom who can find no recruits." *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1181 (1975) (emphasis in original), *aff'd mem. sub nom, Turner v. F.T.C.*, 580 F.2d 701 (D.C. Cir. 1978).

The Federal Trade Commission has established a test for determining what constitutes a pyramid scheme. Such contrivances

> are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product *and* (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users.

Id. (emphasis in original). The satisfaction of the second element of the *Koscot* test is the *sine qua non* of a pyramid scheme: "As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed." *Id.* We adopt the *Koscot* standard here and hold that the operation of a pyramid scheme constitutes fraud for purposes of several federal antifraud statutes.

B.

Omnitrition argues that because it does not charge for the right to sell its products at the "distributor" level, as a matter of law the first *Koscot* element is not met. We disagree.

Omnitrition's argument improperly focuses only on the "distributor" level of Omnitrition's program. The program is unquestionably *not* a pyramid scheme if only the distributor level is taken into account; the participant pays no money to Omnitrition, has the right to sell products and has no right to receive compensation for recruiting others into the program. The distributor level, however, is only a small part of the entire program. Taking into account the "supervisor" levels, a reasonable jury could conclude the *Koscot* factors are met here.

To become a supervisor, a participant must pay a substantial amount of money to Omnitrition in the form of large monthly product orders. The "payment of money" element of a pyramid scheme can be met where the participant is required to purchase "non returnable" inventory in order to receive the full benefits of the program. *In re Amway Corp.*, 93 F.T.C. 618, 715-16 (1979).[2] In exchange for these purchases, the supervisor receives the right to sell the products and earn compensation based on product orders made by the supervisor's recruits. This compensation is facially "unrelated to the

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[2] Omnitrition argues that its buy-back rule makes the inventory purchased by supervisors "returnable." We address this argument below in our discussion of Omnitrition's "*Amway* defense."

sale of the product to ultimate users" because it is paid based on the suggested retail price of the amount *ordered* from Omnitrition, rather than based on *actual sales* to consumers.

On its face, Omnitrition's program appears to be a pyramid scheme. Omnitrition cannot save itself simply by pointing to the fact that it makes some retail sales. *See In re Ger-Ro-Mar, Inc.*, 84 F.T.C. 95, 148-49 (1974) (that some retail sales occur does not mitigate the unlawful nature of pyramid schemes), *rev'd on other grounds*, 518 F.2d 33 (2d Cir. 1975). The promise of lucrative rewards for recruiting others tends to induce participants to focus on the recruitment side of the business at the expense of their retail marketing efforts, making it unlikely that meaningful opportunities for retail sales will occur. *Koscot*, 86 F.T.C. at 1181. The danger of such "recruitment focus" is present in Omnitrition's program. For example, Webster testified that Omnitrition encouraged him to "get to supervisor as quick as [he] could." Ligon states:

> [T]he product sales are driven by enrolling people. In other words, the people buy exorbitant amounts of products that normally would not be sold in an average market by virtue of the fact that they enroll, get caught up in the process, in the enthusiasm, the words of people like Charlie Ragus, president, by buying exorbitant amounts of products, giving products away and get[ting] involved in their proven plan of success, their marketing plan. It has nothing to do with the normal supply and demand in this world. It has to do with getting people enrolled, enrolling people, getting them on the bandwagon and getting them to sell product.

Omnitrition argues that Webster failed to submit sufficient admissible proof that Omnitrition is a pyramid scheme. We disagree. The mere structure of the scheme suggests that Omnitrition's focus was in promoting *the program* rather than selling *the products.* When added to statements from Webster's and Ligon's depositions, plaintiffs have produced sufficient evidence to defeat summary judgment.

C.

To rebut the pyramid allegations, Omnitrition relies heavily on *In re Amway Corp.*, 93 F.T.C. 618 (1979), in which the FTC found Amway was not a pyramid scheme because its policies prevented inventory loading and encouraged retail sales. *Id.* at 715-16. Omnitrition argues that its formal adoption of policies similar to Amway's was sufficient to support summary judgment. We disagree.

The policies adopted by Amway were as follows: (1) participants were required to buy back from any person they recruited any saleable, unsold inventory upon the recruit's leaving Amway, (2) every participant was required to sell at wholesale or retail at least 70% of the products bought in a given month in order to receive a bonus for that month, and (3) in order to receive a bonus in a month, each participant was required to submit proof of retail sales made to ten different consumers. *Id.* at 716. The Administrative Law Judge ("ALJ") in *Amway* found as a matter of fact that these policies were enforced by Amway, and, more importantly, that the rules *in fact*

served to encourage retail sales and prevent "inventory loading" by Amway distributors.[3] *Id.* at 646, 668.

Omnitrition has distribution rules modeled on Amway's. However, the existence and enforcement of rules like Amway's is only the first step in the pyramid scheme inquiry. Where, as here, a distribution program appears to meet the *Koscot* definition of a pyramid scheme, there must be evidence that the program's safeguards are enforced and actually serve to deter inventory loading and encourage retail sales. In *Amway*, the ALJ made that crucial finding of fact, after a full trial. *See id.* at 631. Our review of the record does not reveal sufficient evidence to establish as a matter of law that Omnitrition's rules *actually work*.

Further, Omnitrition's rules, while carefully crafted to appear like those in *Amway*, are weaker in operation. The key to any anti-pyramiding rule in a program like Omnitrition's, where the basic structure serves to reward recruitment more than retailing, is that the rule must serve to tie recruitment bonuses to actual retail sales in some way. Only in this way can the second *Koscot* factor be defeated. Omnitrition has failed to prove that as a matter of law its rules operate in that manner.

First, Omnitrition produced evidence of enforcement only for its ten customer rule. Even assuming that Omnitrition's enforcement measures are effective, it is not clear that these measures serve to tie the *amount* of "Royalty

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[3] "Inventory loading" occurs when distributors make the minimum required purchases to receive recruitment-based bonuses without reselling the products to consumers.

Overrides" to retail sales. The overrides are paid based on purchases by supervisors. In order to be a supervisor, one must purchase several thousand dollars worth of product each month. That some amount of product was sold by each supervisor to only ten consumers each month does not insure that overrides are being paid as a result of actual retail sales.[4]

Second, Omnitrition produced no evidence of enforcement of its 70% rule. It merely states that, in order to place further orders IMAs must "certify" that they have sold 70% of the product they previously ordered. There is no evidence that this "certification" requirement actually serves to deter inventory loading. Importantly, the requirement can be satisfied by *non-retail* sales to a supervisor's own downline IMAs. This makes it less likely that the rule will effectively tie royalty overrides to sales to ultimate users, as *Koscot* requires.

In addition, plaintiffs have produced evidence that the 70% rule can be satisfied by a distributor's personal use of the products. If *Koscot* is to have any teeth, such a sale cannot satisfy the requirement that sales be to "ultimate users" of a product.[5]

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[4] The same logical criticism could be made of Amway's ten customer rule. It is crucial, however, to keep in mind that Amway's rule was found to be effective as a matter of fact.

[5] Indeed the record indicates that Omnitrition itself does not treat distributors' use of products as retail sales: distributors who purchase products for personal use are not entitled to the same 30 day money back guarantee that is available to other retail customers.

Third, Omnitrition has not shown that it enforces its buy-back rule, or the extent to which Omnitrition has actually repurchased product from disappointed IMAs. In addition, by Omnitrition's own terms, the rule is weaker than Amway's in two particulars: (1) Omnitrition only refunds 90% of the price of the product and (2) Omnitrition will only repurchase consumable products (the majority of what it sells) if they are less than three months old. The latter fact is very significant. The buy-back rule is only effective if it can reduce or eliminate the possibility of inventory loading by insuring that program participants do not find themselves saddled with thousands of dollars worth of unsaleable products. Omnitrition's rule potentially would not achieve this goal for any person who participated in the program for more than three months.

Omnitrition misreads *Amway* as holding that any "multi level marketing" program employing policies like Amway's is not a pyramid scheme as a matter of law. That was not the FTC's holding. The FTC held that Amway was not a pyramid scheme as a matter of fact because its policies were *enforced* and were *effective* in encouraging retail sales. This ruling does not help Omnitrition at the summary judgment stage.

Omnitrition's *Amway* defense must fail, at least on summary judgment, because the crucial evidence of the actual *effectiveness* of its anti-pyramiding distribution rules is missing.

III

We reverse summary judgment for Omnitrition on Webster's securities claims.

A.

In *S.E.C. v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973), we declared that investments in a pyramid scheme were "investment contracts" and thus securities within the meaning of the federal securities laws. If Omnitrition's program is a pyramid scheme, investments in the program's supervisor positions are securities.

An investment contract is a transaction in which "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.* at 481 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)). Omnitrition argues that the success of a participant in its program depends on the participant's own efforts and "hard work." We have rejected a strict interpretation of the "solely from the efforts of others" requirement, however, in favor of a flexible approach that focuses on "whether the efforts made by those other than the investor are the undeniably significant ones." *Id.* at 482.

In *Glenn W. Turner*, we determined in the context of the "Dare to be Great" pyramid scheme that the fact that investors in the scheme were required to exert some effort did not automatically preclude a finding that the investments were securities. Instead, we focused on the fact that the scheme's promoters controlled the methods

by which the product was sold and new members were recruited. The promoters provided the "essential managerial efforts which affect[ed] the failure or success of the enterprise." *Id.* at 483.

The same is true of Omnitrition's program. Plaintiffs claim they were taught to sell Omnitrition's "proven plan of success" and to "catch a wave of return that was far beyond anything that [they] were involved in personally." By the very structure of a pyramid scheme, participants' efforts are focused not on selling products but on recruiting others to join the scheme. Under the reasoning of *Glenn W. Turner,* this is enough to bring investments in the program within the definition of "investment contracts."

If Omnitrition's program involves the sale of securities, Omnitrition is liable under § 12(1) for failing to file a registration statement. Section 12(1) imposes civil liability on one who "offers or sells a security in violation of section 77e." 15 U.S.C. § 77*l*(1) (1981). Section 77e(c) makes it unlawful "to offer to sell . . . any security, unless a registration statement has been filed as to such security . . . " 15 U.S.C. § 77e(c) (1981). There is no scienter requirement to § 12(1). *Wolf v. Banco Nacional De Mexico,* 549 F.Supp. 841, 853 (N.D. Cal. 1982), *rev'd on other grounds,* 739 F.2d 1458 (9th Cir. 1984), *cert. denied,* 469 U.S. 1108 (1985).

B.

The district court concluded that all of the allegedly fraudulent statements Webster attributes to the defendants were statements of opinion not actionable under § 12(2) and Rule 10b-5. We disagree.

We have set out a three part test for the determination of when a statement of opinion is actionable under federal securities laws. *See In re Apple Computer § Litigation,* 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied,* 496 U.S. 943 (1990). There, we stated:

> A projection or statement of belief contains at least three implicit factual assertions: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A projection or statement of belief may be actionable to the extent that one of these implied factual assertions is inaccurate.

Id.

Because there is a material question of fact as to whether Omnitrition's marketing program is a pyramid scheme, there are also material questions of fact regarding whether any of the three *Apple* factors are met with respect to statements promoting the scheme. If defendants operated a pyramid scheme, the third *Apple* factor could not be satisfied by any statement implying that participants could make back their investment in the

scheme.[6] Pyramid schemes are destined to collapse, and the most recent entrants to lose their money. This fact would always be present to undermine the truth of promotional statements.

C.

We reverse summary judgment for Omnitrition on plaintiffs' § 10 and § 12(2) claims.

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . " 15 U.S.C. 78j(b). Securities and Exchange Commission Rule 10b-5 prohibits engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5(c). Federal antifraud securities laws are to be construed broadly. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983).

We hold that operation of a pyramid scheme violates 10b-5's prohibition against engaging in an "act, practice or course of business which operates as a fraud or deceit upon any person." A jury could rationally conclude that

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[6] For example, plaintiffs allege and Omnitrition does not dispute that one defendant stated "[t]hat people who join Omnitrition now [in January 1992] will position themselves for great wealth in the 1990's." The class alleges dozens of similar statements.

the promotion of a pyramid scheme demonstrates the necessary fraudulent intent. *See In re Software Toolworks, Inc. § Litigation*, 50 F.3d 615, 628-29 (9th Cir.) (holding summary judgment on 10b-5 claim to be improper, even in absence of direct evidence of fraudulent intent, where evidence permitted a "reasonable inference" of scienter), *cert. denied*, 116 S.Ct. 274 (1995). Because there is a genuine dispute of material fact as to whether Omnitrition operated a fraudulent pyramid scheme, the district court should not have granted summary judgment on Webster's 10b-5 claims.

Section 12(2) imposes civil liability on any person who "offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . " 15 U.S.C. § 77*l*(2). There is genuine dispute over whether Omnitrition made false statements of fact when it declared Omnitrition was not a pyramid scheme. Even absent such statements, a company which promotes an inherently fraudulent pyramid scheme "omits to state a material fact" for purposes of § 12(2) when it does not explain that the program is bound to collapse.

There is a scienter requirement to § 12(2), but *defendants* bear the burden to prove that they "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . " 15 U.S.C. § 77*l*(2). They have not met this burden at the summary judgment stage.

IV

The district court granted summary judgment for defendants on Webster's civil RICO claims (*see* 18 U.S.C. § 1962(c) and (d)) on two grounds: The absence of predicate acts and the lack of proof of an "enterprise" beyond the alleged racketeering activity itself. We find there exists a genuine issue of material fact, and therefore we reverse the district court.

A.

Because there is a triable issue of fact as to whether Omnitrition was operating an inherently fraudulent pyramid scheme, there also is a triable issue of fact as to whether Omnitrition's promotion of the scheme and use of the mails and wires in furthering the scheme constituted securities fraud, mail fraud and wire fraud respectively.[7] All of these are predicate racketeering acts sufficient to allow plaintiffs to invoke civil RICO. 18

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[7] Mail fraud makes it illegal "to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . . " 18 U.S.C. § 1341. Wire fraud, 18 U.S.C. § 1343, has the same expansive test. An inherently fraudulent pyramid scheme that meets the *Koscot* factors would fall within these broad definitions of fraud.

Securities fraud violations under 10b-5 and § 12(2) are predicate acts for RICO. *See Laird v. Integrated Resources, Inc.*, 897 F.2d 826, 838 (5th Cir. 1990) (10b-5); *Metromedia Co. v. Fugazy*, 753 F.Supp. 93, 98 (S.D.N.Y. 1990), *aff'd as amended on other grounds*, 983 F.2d 350 (2d Cir. 1992), *cert. denied*, 113 S.Ct. 2445 (1993) (§ 12(2)). As discussed above, plaintiffs survive summary judgment on these claims.

U.S.C. §§ 1961(1)(B) (mail and wire fraud) and 1961(1)(D) (securities fraud).

Omnitrition claims Webster has failed to produce evidence that defendants specifically intended to defraud anyone. Specific intent to defraud may be proven circumstantially, and is ill-suited for adjudication on summary judgment. *Ikuno v. Yip*, 912 F.2d 306, 310 (9th Cir. 1990). Facts showing the creation and operation of a pyramid scheme are indications of specific intent to defraud sufficient to survive summary judgment. *See People v. Bestline Products, Inc.*, 132 Cal. Rptr. 767, 788 (Cal. App. 1976) (The "vice and quicksand nature of 'endless-chain' transactions . . . is so apparent that the promoters must be charged with knowledge of the fraud inherent in it.") (quoting *State By Lefkowitz v. ITM, Inc.*, 275 N.Y.S.2d 303, 315 (N.Y. Sup. 1966)); *see generally Ikuno*, 912 F.2d at 311 (finding for purposes of RICO that the existence of a fraudulent scheme "reveals implied if not express intent to defraud.").

B.

Omnitrition argues that Webster must show the existence of an ascertainable structure of the enterprise apart from the alleged racketeering activity (i.e. the operation of a pyramid scheme).[8] The participation of a corporation

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[8] The circuits are split on whether RICO requires the existence of an "ascertainable structure distinct from that inherent in the conduct of a pattern of racketeering activity." *United States v. Blinder*, 10 F.3d 1468, 1473 (9th Cir. 1993) (internal quotations omitted). Because Webster has offered evidence of a separate structure, we find it unnecessary to

in a racketeering scheme is sufficient, of itself, to give the enterprise a structure separate from the racketeering activity: "corporate entities ha[ve] a legal existence separate from their participation in the racketeering, and the very existence of a corporation meets the requirement for a separate structure." *United States v. Feldman*, 853 F.2d 648, 660 (9th Cir. 1988), *cert. denied*, 489 U.S. 1030 (1989) (citing *United States v. Kirk*, 844 F.2d 660, 664 (9th Cir.), *cert. denied*, 488 U.S. 890 (1988)). Omnitrition argues a corporation allegedly set up to conduct only illegal activities (e.g. operate a pyramid scheme) cannot be an enterprise with a structure separate from the racketeering activity. This argument misconstrues the nature of the separate structure requirement. *See, e.g., United States v. Riccobene*, 709 F.2d 214, 223-24 (3d Cir.), *cert. denied*, 464 U.S. 849 (1983). Wholly unlawful enterprises fall within RICO's provisions. *United States v. Tille*, 729 F.2d 615, 620 (9th Cir.), *cert. denied*, 469 U.S. 845 (1984).

C.

Section 1962(d) prohibits conspiracy to violate RICO. Defendants argue that a corporation cannot engage in a RICO conspiracy with its own officers and representatives. We disagree.

In *Ashland Oil, Inc. v. Arnett*, 875 F.2d 1271 (7th Cir. 1989), the court found that intracorporate conspiracies were actionable under RICO, while distinguishing the Supreme Court's contrary ruling in antitrust cases:

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decide whether a RICO plaintiff can state a cause of action without offering proof of a separate structure.

> Since a subsidiary and its parent theoretically have a community of interest, a conspiracy "in restraint of trade" between them poses no threat to the goals of antitrust law – protecting competition. In contrast, intracorporate conspiracies do threaten RICO's goals of preventing the infiltration of legitimate businesses by racketeers and separating racketeers from their profits.

Id. at 1281.[9] We agree with the reasoning of our sister circuit, and hold that § 1962(d) applies to intracorporate conspiracies. *Cf. United States v. Benny*, 786 F.2d 1410, 1416 (9th Cir.) (stating that the corporate form is the "sort of legal shield for illegal activity that Congress intended RICO to pierce"), *cert. denied*, 479 U.S. 1017 (1986).

V

A.

Whether Omnitrition's program runs afoul of California's laws against false advertising, unfair business practices and fraud is determined under California's statutory definition of "Endless Chain" marketing schemes. California Penal Code § 327 makes it a public offense for any person to operate

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[9] District courts are split on the issue. *Compare Medallion TV Enterprises, Inc. v. SelecTV of California, Inc.*, 627 F.Supp. 1290, 1301 n.7 (C.D. Cal. 1986) (collecting cases which state a "corporation can only act through its officers and representatives, who cannot conspire with corporation of which they are a part"), *aff'd on other grounds*, 833 F.2d 1360 (9th Cir. 1987), *cert. denied*, 492 U.S. 917 (1989), *with Ashland Oil*, 875 F.2d at 1281 n.10 (collecting cases to the contrary).

> any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme.

Cal. Penal Code § 327 (West 1995). This definition is equivalent, if not identical, to the *Koscot* test. Because there is sufficient evidence for a jury to conclude the Omnitrition program fails the *Koscot* test, there also is a genuine issue of material fact as to whether it is an "Endless Chain" scheme under § 327.

Indeed, at least one of the Omnitrition's *Amway* protections is less salient under the California statute. Omnitrition's "70% Rule" allows supervisors to count products sold at wholesale to their own downlines toward their 70 percent sales requirement. This allows supervisors to be compensated on the basis of sales other than "sales made to persons who are not participants in the scheme and who are not purchasing in order to participate in the scheme." *Id.* This is expressly prohibited by the California statute, while it is only implicit in the *Amway* "retail sales" defense.

B.

California Business and Professions Code §§ 17500 *et seq.* make it unlawful for anyone to use false or deceptive marketing practices. The operation and promotion of an Endless Chain scheme within the meaning of Penal Code § 327 is an inherently deceptive marketing practice, actionable under § 17500. *People v. Bestline Products, Inc.*, 132 Cal. Rptr. 767, 789-90 (Cal. Ct. App. 1976).

California Business and Professions Code §§ 17200 *et seq.* create a cause of action for anyone damaged by the defendant's unfair competitive practices. By statutory definition, any illegal business practice is also unfair. Cal. Bus. & Prof. Code § 17200 (West 1995). Thus, if Omnitrition's scheme violates Penal Code § 327, it is actionable under Business and Professions Code § 17200 *et seq.*

C.

The existence of a triable issue of fact as to Omnitrition's operation of a pyramid scheme raises triable issues of fact as to Webster's cause of action for common law fraud. The familiar elements of a fraud cause of action are (1) misrepresentations of material fact, (2) knowledge of falsity, (3) intent to induce reliance, (4) justifiable reliance and (5) resulting damage. *Cicone v. URS Corp.*, 227 Cal. Rptr. 887, 890 (Cal. Ct. App. 1986).

Evidence that the defendants operated an illegal, inherently fraudulent pyramid scheme raises a material question of fact going to the first three elements. Misrepresentations, knowledge and intent follow from the inherently fraudulent nature of a pyramid scheme as a matter

of law. As to justifiable reliance, the defendants have not carried their burden on summary judgment of showing a lack of evidence to prove this element. To the contrary, defendants argue strenuously that their scheme was not fraudulent, and that plaintiffs were justified in relying upon the statements made in the promotional materials. Further, the very reason for the *per se* illegality of Endless Chain schemes is their inherent deceptiveness and the fact that the "futility" of the plan is not "apparent to the consumer participant." *Bestline*, 132 Cal. Rptr. at 788 (quoting *Twentieth Century Co. v. Quilling*, 110 N.W. 174, 176 (Wis. 1907)). Finally, there is a triable issue of fact as to damages. Webster testified that he never made back what he put in to the scheme and Ligon testified that he lost approximately $5,000 in the scheme.

VI

The district court granted summary judgment for the Attorney Defendants on Webster's § 12 and § 10 securities claims because it concluded that the limitation period of the statute of limitations had expired on those claims before the class amended its complaint to add the Attorney defendants. We agree.

A.

Claims under §§ 12(1) and 12(2) of the Securities Act of 1933 (15 U.S.C. §§ 77l(1) and 77l(2)) must be brought within one year of the plaintiff's discovery of the allegedly illegal sale or false statement, respectively. 15 U.S.C. § 77m. Section 10(b) claims also operate under a one year limitation period. *Lampf, Pleva, Lipkind, Prupis &*

Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991). The plaintiffs' discovery of the statement's falsity is sufficient to start the limitation period running. *Winkelman v. Blyth & Co.*, 518 F.2d 530, 531 (9th Cir.), *cert. denied*, 423 U.S. 929 (1975).

Adkins' alleged false statements were made in a videotape published in March of 1992. The class did not amend its complaint to add the Attorney Defendants until November 16, 1993, some twenty months later. The class filed its original complaints on May 22, 1992 (Ligon) and October 14, 1992 (Webster), both more than one year before the Attorney Defendants were added. Both complaints necessarily alleged that Omnitrition's program was a pyramid scheme. By implication, therefore, plaintiffs knew of the alleged falsity in Adkins' statements that the program was *not* a pyramid scheme. At the latest, the statute of limitations began to run when Webster filed his complaint on October 14, 1992, more than a year before the class filed suit against the Attorney defendants under § 12(2) and § 10(b).

Webster makes no claim that Adkins engaged in any specific individual conduct in violation of § 12(1), rather alleging that *all defendants*, severally and in concert, engaged in a continuous course of conduct to sell Omnitrition securities in violation of the registration provisions of 15 U.S.C. § 77e.[10] It is undisputed that, more than one year before filing suit against the Attorney Defendants, plaintiffs knew of the Attorney Defendants' participation

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[10] Section 12(1) (15 U.S.C. § 77l(1)) creates a cause of action for anyone who has purchased securities sold in violation of § 77e.

in Omnitrition and its promotional activities, and knew that Omnitrition had not registered its alleged securities with the Securities and Exchange Commission. The limitations period began to run more that one year prior to the class' amendment to add the Attorney Defendants, and therefore this claim was untimely.

B.

We also affirm the grant of summary judgment for the Attorney Defendants on the RICO claims.

Adkins is not liable under RICO because he did not "participate in the operation or management" of the alleged RICO enterprise. *See Reves v. Ernst & Young*, 113 S.Ct. 1163 (1993). In *Reves*, the Supreme Court refused to hold an accountant who audited company reports "participate[d] in the operation or management of the enterprise" as required for § 1962(c) liability. *Id.* at 1173-74. Following *Reves*, we stated that an attorney who wrote letters, prepared a partnership agreement, and assisted in a Chapter 7 proceeding, failed the "operation or management" test. *Baumer v. Pachl*, 8 F.3d 1341 (9th Cir. 1993).

Adkins had far more involvement in the operation and management of Omnitrition than the defendants in the cases he cites. The attorney in *Baumer* "at no time held any formal position in the limited partnership. Nor did he play any part in directing the affairs of the enterprise." *Id.* at 1344. By contrast, Adkins was an Assistant Secretary of Omnitrition. Adkins states, however, that his role as officer was "purely ministerial in nature." We agree with the district court that Webster has not produced any facts which refute this assertion. Adkins' statements

allegedly promoting the scheme do not constitute participation in the "operation or management" of the enterprise. We find that Adkins' purely ministerial role as "Assistant Secretary" in the corporation is insufficient to warrant liability under § 1962(c).

We also find Webster has produced no evidence showing the Attorney Defendants conspired to violate RICO. *See* 28 U.S.C. § 1962(d). Adkins' statements promoting Omnitrition do not establish that he conspired to participate in the operation or management of the enterprise, as prohibited by § 1962(c). Webster has not alleged that the Attorney Defendants conspired to violate § 1962(a) or (b).

C.

We reverse the district court's summary judgment in favor of the Attorney Defendants on the state law claims under California Business and Professions Code §§ 17200, 17500 *et seq.*, and California common law fraud.

Unlike Omnitrition, Adkins' § 17200 liability cannot be based on violating Cal. Penal Code § 327. Section § 327 only punishes one who "contrives, prepares, sets up, proposes, or operates" an endless chain scheme. Similar to our *Reves* analysis above, we hold Adkins did not have the requisite involvement in the scheme to warrant § 327 liability.

Adkins' statements in the Omnitrition video that Omnitrition's profits are driven by retail sales and that Omnitrition could never be considered a pyramid scheme

are false and misleading statements if Omnitrition's program is found to be a pyramid scheme. Section 17500 makes it unlawful for any person to make an untrue or misleading advertising statement "which is known, or which by the exercise of reasonable care should be known, to be untrue or misleading." Section 17200 prohibits unfair competition, which includes untrue or misleading advertising as defined by § 17500. Adkins' statements also are actionable under California common law fraud.

The Attorney Defendants ask us to dismiss the state law claims against them for lack of pendent jurisdiction. The district court may, in its discretion, refuse to exercise supplemental jurisdiction after considering 28 U.S.C. § 1366. We will not examine the necessary factors in the first instance.

VII

Because we reverse the grant of summary judgment on other grounds, we decline to reach Webster's challenges to the district court's evidentiary and discovery rulings.[11]

The district court's grant of summary judgment for the Attorney Defendants on Webster's securities claims and RICO claims is AFFIRMED. The remainder of the

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[11] None of the proposed evidence or discovery materials relate to whether Adkins was conspiring to participate in Omnitrition's operation or management, or establish plaintiffs' securities claims were timely filed against the Attorney Defendants.

district court's orders granting summary judgment in favor of Omnitrition and the Attorney Defendants is REVERSED, and the case REMANDED for further proceedings.

AFFIRMED IN PART, REVERSED IN PART and REMANDED.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

IN RE OMNITRITION INTERNATIONAL, INC. SECURITIES LITIGATION	MDL No. 965 No. C 92-4133 SBA
THIS DOCUMENT RELATES TO: *WEBSTER V. OMNITRITION*, et al. C-92-4133, SBA	ORDER GRANTING DEFENDANTS OMNITRITION INTERNATIONAL, INC., JIM FOBAIR, ROGER DALEY AND CHARLES RAGUS MOTION FOR SUMMARY JUDGMENT
	(Filed Jul. 26, 1994)

Plaintiffs, former distributors for defendant Omnitrition International, Inc. ("Omnitrition"), bring the above-captioned matter alleging that the defendants violated federal securities laws, the civil RICO statute, and state fraud laws in the creation, promotion and marketing of Omnitrition and its distributorships. On May 11, 1994, defendants Omnitrition, Jim Fobair, Roger Daley and Charles Ragus filed the instant motion for summary judgment or, alternatively, summary adjudication of issues. Defendant Jerry Rubin has filed a joinder in this motion. Plaintiffs have filed a counter-motion for summary adjudication of certain issues. After having reviewed and considered all of the papers submitted in connection with these motions, as well as the arguments of the parties, and being fully informed, the Court finds that the defendants' motion for summary judgment should be granted and plaintiffs' counter-motion should be denied.

BACKGROUND

An individual joins Omnitrition by filling out an application. (Declaration of Jarrett C. Lambert in Supp. of Defs.' Mot. for Summ. J. or, Alternatively, Summ. Adjudication [Lambert Decl.] ¶ 4). Participants were originally required to pay a filing fee, however, Omnitrition later eliminated that requirement. (*Id.*)

Once the application is approved, an individual becomes a participant in the program. Participants are called Independent Marketing Agents ("IMA"). (*Id.*) IMAs begin their association with Omnitrition as ground level sellers of products, called distributors. A distributor is entitled to purchase Omnitrition products at a 20% discount and sell them to the general public. (*Id.* at ¶ 10). There are no obligations to purchase or sell products. (*Id.* at ¶ 6). Distributors are not entitled to receive any bonuses, overrides, or other royalties for having a "downline" (i.e., having a network of distributors subordinate to an IMA). (*Id.* at ¶ 12; Ex. A, at 12-13).

An IMA can also become a supervisor. One can become the lowest level supervisor, the bronze supervisor, by selling $2,000.00 worth of products in a month, or $1,000.00 in two consecutive months. A supervisor is entitled to a 30% discount on Omnitrition products. Moreover, a bronze supervisor receives a 10% retail bonus based upon future sales of their downline, and receives a 4% royalty[1] on 3 generations of qualified supervisors. (*Id.* Ex. A, at 8, 12-13).

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[1] This royalty is referred to as an "override".

There are also silver, gold, and diamond supervisors. (*Id.* Ex. A, 12-13). At these levels, the bonuses and overrides are calculated on the retail sales of certain distributors in their downlines. (*Id.* Ex. A, 10-13). However, in order to qualify for these rewards, all supervisors must also certify that they have made ten retail sales to ten customers per month. (*Id.*)

Plaintiffs are individuals who obtained distributorships with Omnitrition between 1989 and 1992. Plaintiffs contend that Omnitrition is a pyramid scheme. (Amended Complaint, ¶ 24) Omnitrition allegedly created and markets a line of health food products. (Amended Complaint, ¶ 23). However, plaintiffs maintain that Omnitrition did not engage in or encourage retail sale of these products. Rather, plaintiffs maintain Omnitrition actively recruited distributors of the products, who would in turn be encouraged to recruit more distributors. (Amended Complaint, ¶ 24).

DISCUSSION

A. Summary Judgment

Summary judgment is appropriate under Fed. R. Civ. P. 56(b) where there exist no genuine issues of material fact and as a matter of law the moving party is entitled to win. *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). For purposes of the motion, the court must construe the opposing party's papers liberally; resolving all ambiguities and drawing all reasonable inferences in their favor. *Patrick v. LeFevre*, 475 F.2d 153 (2nd Cir. 1984). That being the case, a factual dispute is to be considered genuine only if the non-moving party can offer "concrete

evidence" such that a reasonable jury could return a verdict in their favor. *Anderson v. Liberty Lobby,* 477 U.S. 242, 256 (1986). The burden on the moving party may be discharged by pointing out to the district court that there is an absence of evidence to support the opposing party's claim. *Celotex* at 325.

B. Whether Omnitrition is an Illegal Pyramid Sales Scheme

1. Definition of an Illegal Pyramid Sales Scheme

The Federal Trade Commission (FTC) has formulated a legal definition of an illegal pyramid sales scheme which has been adopted by this Court in *Nguyen v. Fundamerica, Inc.,* 1990 WL 165247 (N.D.Cal. Aug. 21, 1990) (Patel, J.). According to the FTC and the *Nguyen* court, a pyramid sales scheme is a business in which

> a participant pays money to the company or its representatives and, in return receives (1) the right to sell products, and (2) the right to earn rewards for recruiting other participants into the scheme that are unrelated to product sales.

Id. (citing *Federal Trade Commission v. Koscot Interplanetary, Inc.,* 86 F.T.C. 1106 (1975), aff'd sub nom, *Turner v. FTC,* 580 F.2d 701 (D.C.Cir. 1978)); *In re Amway,* 93 F.T.C. 618 (1979). At the hearing on the instant motions, plaintiffs conceded that this definition is the appropriate standard for determining whether a business is an illegal pyramid sales scheme.

Based upon the structure of the Omnitrition system, it is apparent that Omnitrition does not meet the definition of an illegal pyramid scheme. As a threshold matter, the participants in the company, IMAs, do not pay money to obtain sales and/or recruiting rights. As previously mentioned, there is no charge for joining the company. Once the application is approved, the participant obtains the right to buy Omnitrition products at a 20% discount, and the right to sell Omnitrition products. (Lambert Decl. ¶ 4, Ex. A, at 12-13).

More significantly, an IMA does *not* obtain the right to earn rewards for recruiting other participants into the scheme *that are unrelated to product sales.* A participant in Omnitrition does not receive any payment or reward for merely recruiting others into the program. (Lambert Decl. ¶ 12, Ex. A, at 12-13). These new recruits must make retail sales.[2] If the recruiter has achieved a sufficient sales volume to qualify for overrides and/or bonuses, and the new recruits make retail sales, the recruiter receives a payment from Omnitrition based upon a percentage of the retail sales of his downline. Thus, unlike a scheme

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[2] At the hearing, plaintiffs for the first time forwarded the argument that Omnitrition, at the silver, gold and diamond levels, fails the *Nguyen* test. However, given that supervisors at these levels are rewarded solely on the retail sales volume of their downline, these supervisors' rewards are directly related to the sale of products. Thus, Omnitrition meets the *Nguyen* standard. Moreover, in order to maintain one's position as a supervisor, in addition to maintaining a downline, one must also continue to make ten retail sales to ten customers per month. (Lambert Decl. Ex. A, at 12-13).

that falls within the *Nguyen* standard, Omnitrition provides rewards for recruiting participants that are directly related to product sales. In fact, the reward is conditional on product sales, and the amount of the award is based upon the amount of product sales that occur.[3]

Plaintiffs offer no competent or admissible evidence to refute defendants' position. In fact, plaintiffs fail to address the *Nguyen* and FTC test in their papers, though,

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[3] Defendants cite further support for this position by providing the deposition testimony of named plaintiff Shawn Webster:

> Question: . . . You understood at all times that if no retail sales were made by you or your downline you would receive no profit, didn't you?
>
> Answer: Right.
>
> . . .
>
> Question: So it would be fair to say, wouldn't it, that Omnitrition emphasized selling products in connection with being an Omnitrition distributor or IMA?
>
> Ms. Karpen: Asked and Answered.
>
> Answer: Yeah. I already answered that. I mean they did emphasize that. They emphasized –
>
> By Mr. Missing:
>
> Question: And it was an essential part of being an Omnitrition IMA, wasn't it?
>
> Answer: Yes.

(Declaration of James E. Burns, Jr. in Supp. of Defs.' Mot. for Summ. J or, Alternatively, Summ. Adjudication [Burns Decl.], Ex. N at 191-192).

as previously mentioned, plaintiffs conceded at the hearing that the *Nguyen* test is the appropriate standard for determining whether a business is, in fact, an illegal pyramid sales scheme.

2. The *Amway* Safeguards

In its opinion in *In re Amway Corporation*, 93 F.T.C. 618 (1979), the FTC found that certain safeguards employed by a direct marketing company are evidence that a business is not an illegal pyramid sales scheme under the FTC standard relied upon by the *Nguyen* court.

The Amway Corporation sold a variety of home care, car care, and personal care products, as well as vitamin and food supplements. Each Amway distributor had the right to sell Amway products to consumers, to sponsor new Amway distributors and to sell products to his or her sponsored distributors. Amway distributors earned income from retail sales of products, performance bonuses based on a point system and percentage of Amway products purchased for resale; in addition, for those who chose to sponsor other distributors, income could be earned on the total sales volume of the sponsor's personal distributor group. *Id.* at 646.

Amway required that distributors resell 70% of the purchases they made each month. Moreover, Amway had a "ten customer" rule which precluded distributors from receiving a performance bonus unless they could certify sales to ten different retail customers each month. Finally, Amway agreed to refund up to 90% of any unused marketable products from a distributor. *Id.*

The Administrative Law Judge (ALJ), which the FTC was reviewing on appeal, found that these safeguards are evidence that Amway was not a pyramid scheme. The ALJ held that the characteristics of a pyramid scheme are "compensation for recruiting regardless of consumer sales" by means of "headhunting fees" or "commissions on mandatory inventory purchases by the recruits known as 'inventory loading' ". *Id.* at 667.

The FTC upheld the decision, finding that an Amway distributor:

> is not required to pay a headhunting fee or buy a large amount of inventory to become an Amway distributor. The only purchase a new distributor is required to make is a $15.60 Sales Kit, which contains Amway literature and sales aids; no profit is made in the sale of this Kit, and the purchase price may be refunded if the distributor decides to leave the business. Thus a sponsoring distributor receives nothing from the mere act of sponsoring. It is only when the newly recruited distributor begins making wholesale purchases from his sponsor and sales to consumers, that the supervisor begins to earn money from his recruits efforts . . .
>
> The ALJ found that the buy-back rule, the 70 percent rule, and the ten-customer rule are enforced, and that they serve to prevent inventory loading and encourage retailing. [Citation omitted.] Given these facts, the Amway plan is significantly different from the pyramid plans condemned in *Koscot*, *Ger-Ro-Mar*, and *Holiday Magic*. Specifically, the Amway plan is not a plan where participants purchase the right to earn profits by recruiting other participants,

> who themselves are interested in recruitment fees rather than retail sales.

Id. at 715-17.

At least one California state appellate court has adopted the *Amway* test. In *Bounds v. Figurettes, Inc.*, 135 Cal.App.3d 1, 21-22 (1982), the court reviewed the *Amway* decision and found that defendants, though they sold products in addition to recruiting distributors, was a pyramid scheme, as the defendants did not have the *Amway* safeguards. Specifically, the Figurettes defendants had a headhunting fee, did not make product sales a precondition of receiving bonuses, did not have a buy-back provision, and did not require a substantial percentage of products be sold to consumers at retail. *Id.*

Defendants maintain, and plaintiffs do not dispute, that Omnitrition has implemented safeguards identical to those employed by the Amway Corporation. Omnitrition has no headhunting fee. (Lambert Decl., ¶ 6). Omnitrition IMAs must certify on each product form that at least 70% of the products previously purchased had been sold. (*Id.* at ¶ 15). To receive *any* bonuses or royalties for sales by one's downline, a supervisor must first certify that he or she made at least ten retail sales to ten different retail consumers each month. (*Id.* at ¶ 13). Also, if an IMA cannot or chooses not to sell products he or she has purchased, Omnitrition will provide a 90% refund for the cost of non-consumable products if returned within twelve months, and within three months for consumable products. (*Id.* at ¶ 7).

Plaintiffs contend, however, that the *Amway* safeguards are insufficient to insure that Omnitrition is not a

pyramid scheme. Specifically, plaintiffs contend that the safeguards do not insure retail sales or prevent inventory loading.[4] Moreover, plaintiffs insist that Omnitrition does not effectively enforce the 70% and ten-customer rules.

Plaintiffs offer no competent or admissible evidence to support their positions. Rather, plaintiffs rely on the alleged Declaration of Dr. Itamar Simonson, an associate professor of marketing at the Graduate School of Business, Stanford University. (Alleged Decl. of Dr. Itamar Simonson in Opp'n to Defs.' Mot. for Summ. J. [Alleged Simonson Decl.] ¶ 1). However, the declaration presented to the Court was not signed by Dr. Simonson and was consequently stricken from the record.[5]

Even if the Court were to consider the purported declaration of Dr. Simonson, the Court would find it wholly unpersuasive. In relevant part, Dr. Simonson allegedly testified that only $10 million of Omnitrition's approximately $51 million in sales for 1993 were the result of retail sales.[6] Dr. Simonson allegedly reached this

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[4] It is important to note that the FTC in *Amway* did not hold that the safeguards would *insure* retail sales; rather, the FTC found the safeguards significant because they would *encourage* retail sales. Plaintiffs offer no evidence that Omnitrition's safeguards fail to *encourage retail sales.*

[5] As is more thoroughly discussed in the Court's Order of July 6, 1994 denying plaintiffs' motion for reconsideration of the Order striking Dr. Simonson's declaration and order to show cause re: sanctions, the Court had several serious concerns regarding the circumstances surrounding plaintiffs' submission of this declaration.

[6] Dr. Simonson allegedly also testified that Omnitrition was incapable of making retail sales because its products were of

$10 million figure by reviewing an analysis performed by an unidentified individual.[7] (Alleged Simonson Decl. ¶ 25, at 20-22). This individual allegedly reviewed a group of Form 1025s, the forms which Omnitrition supervisors must submit to demonstrate the requisite monthly ten retail sales to ten customers to render them eligible for overrides and bonuses. The individual considered a total of 169 forms consisting of the third form from each month of a file encompassing the period November of 1992 to March of 1994. The individual then allegedly estimated that 1,400 to 1,500 forms would be submitted to Omnitrition in a month, and calculated the average

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little value. Dr. Simonson allegedly relied upon the Declaration of Dr. Judith S. Stern, a professor of nutrition and internal medicine at the University of California at Davis. (Alleged Simonson Decl. ¶ 6, 9) However, several individuals who purchased these products have testified that they were beneficial, including both named plaintiffs in this action, Shawn Webster and Robert Ligon. (Burns Decl. Ex. N, 79-83; Ex. J, 82-87) Moreover, Dr. Simonson contradicts his position by testifying elsewhere in the declaration that several companies have successfully sold these products. (Alleged Simonson Decl. ¶ 10).

[7] Defendants object to this entire section of the declaration, maintaining that it is without foundation and is an improper opinion. The Court concurs. Plaintiffs have failed to identify the person who performed the analysis and the source or basis of his or her information; nor have they provided information concerning his or her qualifications, experience, and training. Thus there is no way for the Court to determine the appropriateness of the procedures employed, the validity of the assumptions made or reasonableness or competency of the resulting conclusions. Were the Court to consider Dr. Simonson's declaration, defendants' objection would have been sustained.

payment made to supervisors based on these forms, $579.00, and multiplied that figure by 1,500 forms, resulting in a total retail sales figure of $868,500.00 per month or approximately $10 million per year. (*Id.* at 21)

Dr. Simonson, however, does not explain what conclusions should be drawn from the difference between his determination Illegible sales totaled $10 million and Omnitrition's total sales of approximately $51.5 million.[8]

Defendants identify several faults with the professors's analysis. For example, the professor assumes, without any apparent basis, that only 1500 Form 1025s are received each month.[9] As defendants note, the plaintiffs and the professor had in their possession Form 1025s

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[8] However, at other points in the declaration, Dr. Simonson suggests that Omnitrition's sales are the result of inventory loading by participants attempting to earn overrides and bonuses from sales from their downlines. (Alleged Simonson Decl. ¶ 9) Plaintiffs draw a similar conclusion in their motion papers. (Pl.s' Opp'n to Def.s' Mot. for Summ. J. at 6) In support of this assertion, both Dr. Simonson and plaintiffs refer to statements allegedly made by defendant Jerry Rubin that suggest that Omnitrition's products are merely a "hook" to luring people into the system. (Alleged Simonson Decl. ¶ 9; Pl.s' Opp'n to Def.s' Mot. for Summ. J. at 6.) Plaintiffs cite to a document attached to the Declaration of Andrew Lamis in support of this position. (Decl. of Andrew P. Lamis in Opp'n to Defs.' Mot. for Summ. J. Ex. R.) However, as defendants point out, this statement is not located in the document attached to the Lamis Declaration. (*See* Def.s' Reply Mem. in Supp. of Mot. for Summ. J. at 17 n. 16). Moreover, defendants' objection to this document, on the ground that it has not been properly authenticated, is sustained. *See Zosko v. MCA Distributing Co.*, 693 F.2d 870 (9th Cir. 1982), *cert. denied* 460 U.S. 1085 (1985).

[9] At the hearing, the parties noted that Omnitrition generates several thousand Form 1025s in a month.

for the period in question; thus, they simply could have counted the average number of forms received in one month. (Defs.' Reply Mem. in Supp. of Mot. for Summ. J. at 13). This raises a more fundamental question concerning plaintiffs' reasons for utilizing such a small sample size as well as the resulting accuracy of the survey. Neither Dr. Simonson nor the plaintiffs explain how its survey is representative of Omnitrition's total sales.

Moreover, it is not apparent that the basic assumption underlying Dr. Simonson's conclusions – that Form 1025s are an appropriate measure of the total retail sales – is valid. As defendants note, and plaintiffs do not dispute, Form 1025s reflect only a portion of all retail sales. For example, a supervisor who makes fifty retail sales in a month is only required to report ten of those sales on a Form 1025. Moreover, as the penalty for failing to file Form 1025s is the withholding of bonuses and overrides, there is no apparent incentive for distributors, who are not eligible for bonuses or overrides, to submit these forms; thus, these sales would not be accounted for in Dr. Simonson's analysis. (*See* Lambert Decl. ¶ 12, Ex. 12-13)[10] Finally, Form 1025s do not reflect products purchased by distributors for personal consumption. Clearly, a sale of

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[10] Dr. Simonson allegedly testified that a distributor's lack of incentive to submit Form 1025s is evidence that these forms do not encourage retail sales. (Alleged Simonson Decl. ¶ 25, at 21). This argument is unpersuasive. It is not readily apparent what incentive a distributor would have to make non-retail sales or engage in inventory loading, since a distributor cannot obtain bonuses or overrides from the sales related to his or her downline. (Lambert Decl. ¶ 12, Ex. A, 12-13)

Omnitrition products to an individual who uses them is a retail sale.

More significantly, as defendants noted in their papers and at the hearing, if Dr. Simonson's analysis were correct, there would be some evidence that participants in Omnitrition engaged in inventory loading. In other words, if IMAs bought Omnitrition products to advance in the company's hierarchy, the IMAs would possess unwanted products. (Defs. Sep. Statement of Facts, ¶¶ 45, 48, 50). However, defendants maintain, and plaintiffs do not dispute, that there is no evidence that any Omnitrition participant purchased products they did not want for their own use or were unable to sell. There is no evidence before the Court which demonstrates that Omnitrition's approximately $51.5 million in sales are attributable to anything other than retail sales. Tellingly, there in fact is no evidence that any Omnitrition IMA lost money through participation in the company.

Dr. Simonson also allegedly testified that Omnitrition failed to adequately enforce their ten-customer rule. (Alleged Simonson Decl. ¶ 25, at 21-22). However, Dr. Simonson's position was unsupported by any competent evidence. Dr. Simonson allegedly testified, without any apparent basis, that the punishments exacted for failing to comply with the ten-customer rule were not significant. Defendants maintain that withholding bonuses and overrides is a significant punishment, as evidenced by the testimony of Joseph Beasy, who had a check of almost $9,000.00 withheld pending resolution of a discrepancy in his Form 1025. (Burns Decl. Ex. D, at 102-105).

Moreover, the Amway Corporation employed the same ten-customer rule, but utilized a weaker enforcement mechanism. Specifically, Amway required a distributor to submit proof to his sponsor and direct supervisor concerning Form 1025s. *In re Amway Corporation*, 93 F.T.C. at 716. By contrast, Omnitrition checked Form 1025s itself, through the use of random verifications. (Burns Decl. Ex. K, at 113-114). Mr. Rick Williams, a data entry operator for Omnitrition's Retail Sales and Compliance Department, testified that he and other omnitrition employees made telephone calls to customers listed on Form 1025S to verify that retail sales occurred and to encourage repeat sales. (*See* Burns Decl., Ex. O, at 10-28).

Plaintiffs suggest that an insubstantial percentage of Form 1025s were ever reviewed and verified by Omnitrition. (Alleged Simonson Decl., ¶ 25, at 21-22). However, plaintiffs have failed to provide competent or admissible evidence in support of this conclusion. By contrast, Mr. Rick Williams testified that the Omnitrition Retail Sales and Compliance Department made approximately one thousand calls to verify Form 1025s each month. (Burns Decl., Ex. O, at 23-24). Plaintiffs fail to forward any standard by which the Court could conclude that these enforcement efforts were not substantial.

In addition, as previously discussed, there is no evidence that Omnitrition's ten-customer rule, and therefore its enforcement mechanism, was ineffective. There is no evidence that any participant possessed unwanted products, or, more significantly, that any IMA ever lost money through participation in Omnitrition. Finally, as previously mentioned; the FTC found the *Amway* safeguards to be significant because they *encouraged*, rather than

insured, retail sales. Plaintiffs have offered no competent or admissible evidence that Omnitrition's safeguards failed to do either.[11]

Plaintiffs have not forwarded any competent evidentiary support for their assertion that Omnitrition is an illegal pyramid scheme. As the preceding discussion demonstrates, even if it did not strike the purported Simonson Declaration and instead treated it as competent evidence, the Court would find the declaration wholly unpersuasive and without merit.

Accordingly, under the *Nguyen* standard, and after considering Omnitrition's use of the identical safeguards employed by the Amway Corporation, the Court finds that Omnitrition does not conform to the legal definition of an illegal pyramid sales scheme.[12]

C. Whether Omnitrition Distributorships Are Securities Pursuant to § 12 of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934

Defendants maintain that Omnitrition distributorship are not securities pursuant to Section 12 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange

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[11] Plaintiffs challenges to Omnitrition's 70% rule and buy-back/refund rule are also deficient, in that they are without any competent or admissible evidentiary support.

[12] Plaintiffs' counter-motion for summary adjudication of certain issues is directed solely to the issue of whether Omnitrition falls within the legal definition of an illegal pyramid sales scheme. Accordingly, the counter-motion is denied.

Act of 1934. To establish that a transaction involves securities, the Court must determine whether the scheme involves an investment of money in a common enterprise with profits derived solely from the efforts of others. *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946).

The Ninth Circuit has interpreted the *Howey* requirement that a participant's profits be generated "solely from the efforts of others," to mean "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

In *Glenn Turner*, "investors" who purchased an "educational course" were allowed to collect commissions from others when these "investors" brought these recruits to recruitment seminars and were eventually signed onto the program. The trial court found that the benefit of earning these commissions "is in all respects the significant one," *Glenn Turner*, 474 F.2d at 478. The Court held that

> In this case, Dare's source of income is from selling the Adventures and the Plan. The purchaser is sold the idea that he will get a fixed part of the proceeds of the sale. In essence, to get that share, he invests three things: his money, his efforts to find purchasers and bring them to the meetings, and whatever it costs him to create an illusion of his own affluence. He invests them in Dare's get-rich-quick scheme. In our view, the scheme is no less an investment contract merely because he contributes some effort as well as money to get into it.

Glenn Turner, 474 F.2d at 481. To hold otherwise, the Court believed, would allow individuals to evade the law by adding a requirement to their schemes that the buyer contribute a modicum of effort. *Id.*

Defendants allege that all participants in Omnitrition, even those who receive compensation based upon the products sales of their downlines, must engage in significant individual effort in order to obtain any benefits from being a distributor or supervisor. (*See* Lambert Decl. Ex. A). All participants must engage in retail sales. (*Id.*) As previously mentioned, even at the upper levels of the Omnitrition hierarchy, supervisors must make at least ten retail sales to ten customers in each month in order to qualify for bonuses and overrides. (*Id.*) Moreover, several Omnitrition IMAs, including plaintiffs Shawn Webster and Robert Ligon, testified that they spend twenty to twenty-five hours per week on their Omnitrition businesses. (Burns Decl. Ex. N, at 75, Ex. J, at 105-07). Other Omnitrition participants testified that they worked as many as fifteen hours a day building up their distributorships. (Burns Decl. Ex. D, at 95, 126-28; Ex. E, at 54-56; Ex. I, at 108,131-34; Ex. L, at 89-90). Each of these distributors also testified that they knew that their distributorships would necessitate hard work on their part. (*Id.*)

Given the testimony of these Omnitrition participants, including both named plaintiffs in this action, and the complete absence of any evidence to contradict this testimony, it is quite evident that Omnitrition distributorships do not depend primarily upon the efforts of others and Omnitrition participants are "not the passive investor[s] intended to be concerned by the federal security

laws." *Bitter v. Hoby's International Inc.*, 498 F.2d 183, 185 (9th Cir. 1974).

Accordingly, given the holding of *Howey* and its progeny, as well as the testimony of the named plaintiffs in this action, Omnitrition distributorships are not securities for purposes of § 12 of the Securities Act of 1933 and the Securities Exchange Act of 1934.

D. Whether Defendants' Statements and Alleged Omissions Are Actionable Pursuant to Section 12(2) of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934

Defendants maintain that even if Omnitrition distributorships can be properly characterized as securities, none of the statements allegedly made by the defendants, as set out in paragraph 37 and 38 of the amended complaint, are actionable under the security laws. Defendants contend that these statements are merely opinions and "puffing" and thus are not actionable.

In general, statements of opinion are not actionable. *See Presidio Enterprises, Inc. v. Warner Bros. Distrib. Corp.*, 784 F.2d 674, 679 (5th Cir. 1986). Opinions as to the success of companies or products, including statements that a product will be a "blow-out winner," *In re Technologies Securities Litigation*, 804 F.Supp. 1368, 1372 (D. Colo. 1992), or that a company is a "market leader" and "well-positioned" for growth, *In re Caere Corporation Securities Litigation*, 837 F.Supp. 1054, 1057 (N.D.Cal. 1993), or that a stock is so "red hot" that the investor cannot lose, *Rothstein v. Reynolds & Co.*, 359 F.Supp. 109, 113 (N.D.Ill. 1973),

should be understood by reasonable investors as "mere puffing." *Storage Technologies*, 804 F.Supp. at 1372.

However, the Ninth Circuit, in *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied* 496 U.S. 943 (1990), has set out a three part test for determining when statements of opinion may be actionable in securities fraud cases.

> A projection or statement of belief contains at least three implicit factual assertions: 1) that the statement is genuinely believed, 2) that there is a reasonable basis for that belief, and 3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A projection or statement of belief may be actionable to the extent that one of these implied factual assertions is inaccurate.

Id.

Plaintiffs have challenged every statement on the ground that Omnitrition is a pyramid scheme that was destined to collapse, and that each defendant knew this to be true. However, as previously discussed, Omnitrition does not meet the legal definition of an illegal pyramid sales scheme.[13] Accordingly plaintiffs' claims that Omnitrition is inherently destined to collapse are unsupportable.[14]

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[13] Thus, defendants' statements that Omnitrition is not an illegal pyramid scheme are also not actionable as misstatements of fact, since defendants' statements are technically correct.

[14] Plaintiffs submit evidence which demonstrates that a relative minority of Omnitrition distributors made significant amounts of money through participating in the company. (Decl.

Moreover, defendants have each submitted declarations in which they maintain that they genuinely believed and continue to believe that every statement they made is true. (Daley Decl. ¶ 3,4,6; Decl. of James Fobair ¶ 3,4,6; Decl. of Charles Ragus ¶ 3,4,6). Defendants have therefore met the first prong of the *Apple* test.

Each defendant also testified that he had a reasonable basis for believing the statements to be true. For example, defendant Fobair maintains that he believes Omnitrition is not a pyramid scheme based upon his emphasizing to Omnitrition participants the importance of hard work to build and maintain a distributorship, as well as Omnitrition's emphasis on retail sales and its reliance on its retail sales rules. (Decl. of James Fobair, ¶ 4,5). Defendants Daley and Ragus have testified similarly. (Decl. of Charles Ragus, ¶¶ 4,5; Daley Decl ¶¶ 4,5) Plaintiffs have not forwarded any evidence or argument suggesting that defendants' bases for believing their statements to be true were unreasonable, thus, defendants have met the second prong of the *Apple* test.

Finally, plaintiffs have to forwarded any evidence suggesting that any defendant was aware of undisclosed

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of Andrew P. Lamis in Opp'n to Defs.' Mot. for Summ. J. Filed Under Seal). However, plaintiffs fail to identify any statements by the defendants in which claims are made concerning the likelihood of making significant amounts of money in Omnitrition. Moreover, it is not readily apparent how the income structure of Omnitrition, and the claims about its success, are different from any other company transacting business consistent with the security laws.

facts tending to seriously undermine the accuracy of each statement. Thus, the third prong of the *Apple* test is met.[15]

E. Plaintiffs' Claims Pursuant to § 10(b) of the Securities Exchange Act of 1934

1. Whether Defendants Acted With the Requisite Scienter

Scienter is a necessary element in an action for damages under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, 17 C.F.R. § 240:10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied* 496 U.S. 943 (1990). Scienter may be established by proof of either actual knowledge of falsity or recklessness. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991).

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[15] Defendants also challenge plaintiffs' allegations that defendants made actionable omissions of fact. Plaintiffs allege, in paragraph 48 of the amended complaint, that defendants have failed to disclose that Omnitrition is a pyramid scheme, or that defendant failed to disclose their prior association with another network marketing company, Herbalife. Plaintiffs do not address either of these arguments.

The first alleged omission is clearly not actionable, since, as previously mentioned, Omnitrition does not fall within the legal definition of a pyramid scheme. Plaintiffs have failed to explain the relevance of the second alleged omission, and have not forwarded any evidence that this information was hidden or undisclosed. Moreover, a nondisclosure can be actionable only if it renders an affirmative statement misleading. *Alfus v. Pyramid Technology*, 745 F.Supp. 1511, 1518-19 (N.D.Cal. 1990). Plaintiffs have not identified any statement or fact which would require disclosure of defendants' association with Herbalife.

In a footnote, plaintiffs maintain that "all of the Omnitrition promotional literature, audiotapes, videotapes and transcripts of conference calls raise the triable issue of fact with respect to the scienter of the defendants, i.e. their purportedly 'honest and reasonable belief' that the program they are marketing is not a pyramid scheme." (Pl.s' Opp'n to Defs.' Mot. for Summ. J. at 21 n. 10). However, plaintiffs fail to designate or identify what specifically in these hundreds of pages of material creates this triable issue of fact.[16]

Without proof of a motive for defendant's participation in an alleged fraud, plaintiffs "bear a heavy burden in defeating summary judgment with inferences drawn from circumstantial evidence." *In re Software Toolworks*, 789 F.Supp. 1489, 1499 (N.D.Cal. 1992).

Given their failure to provide any evidence of scienter, plaintiffs have not sustained their burden with respect to this element of their Section 10(b) claims. Therefore, even if Omnitrition distributorships could be properly characterized as securities, and even if the

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[16] Moreover, it is important to note that the Court is not obligated to consider matters not specifically brought to its attention. *See* Schwarzer, Tashima & Wagstaff, *Cal. Prac. Guide: Fed. Civ. Pro. Before Trial* § 14.145.2 (The Rutter Group 1993). The opposition to a summary judgment motion must designate and reference *specific* triable facts. *Frito-Lay v. Willoughby*, 863 F.2d 1029, 1034 (D.C. Cir. 1988) ("failure to designate and reference triable facts was, in light of the language of Rule 56(c) and governing precedent, fatal to its opposition."); *Nissho-Iwai Am. Corp. v. Kline*, 845 F.2d 1300, 1307 (5th Cir. 1988) (rejecting notion that "the entire record must be searched and found bereft of a genuine issue of material fact before summary judgment may be properly entered.")

defendants' alleged statements and omissions were actionable, defendants are entitled to summary judgment on Plaintiffs' § 10(b) claims.

2. Whether Plaintiff Has Provided Evidence of Loss Causation or Damages

To recover under Section 10(b), plaintiffs must prove that defendants' purported misconduct "cause[d] the loss for which they seek to recover." *McGonigle v. Combs*, 968 F.2d 810, 821 (9th Cir.), *cert. dismissed*, 113 S.Ct. 399 (1992). Such loss causation is also a prerequisite to recover for common law fraud. *Bastian v. Petran Resources Corp.*, 892 F.2d 680, 683-86 (7th Cir.), *cert denied* 496 U.S. 906 (1990).

Defendants maintain that there is no evidence that their actions caused anyone financial harm. Plaintiffs have failed to address this issue.

Significantly, defendants contend that there is no evidence that any Omnitrition IMA lost money through participation in the company. Plaintiffs fail to provide any evidence to dispute this position. In fact, named plaintiff Shawn Webster testified that he sold or personally consumed all of the products he purchased, and that as a result he either made a profit or broke even. (Burns Decl. Ex. N., at 360).[17] Ron Cashman – another IMA whose

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[17] At the hearing, plaintiffs suggested that Shawn Webster testified at his deposition that he lost approximately $700.00 through participating in Omnitrition. Plaintiffs failed to identify where this testimony was located. However, a review of Shawn Webster's deposition testimony demonstrates that plaintiffs are incorrect. Nowhere did Shawn Webster testify that he lost any

downline Webster was in – testified that Webster said he made money as an Omnitrition distributor. (Burns Decl. Ex. E. at 150).[18]

3. Plaintiffs' Secondary Liability and Conspiracy Claims for Section 10(b)

The Supreme Court, in *Central Bank of Denver v. First Interstate Bank of Denver*, ___ U.S. ___, 1994 U.S. Lexis 3120 (April 19, 1994), held that plaintiffs may not pursue Rule 10b-5 claims for aiding and abetting.

Defendants maintain that plaintiffs' conspiracy claims must fail as well, as there is no "significant probative evidence" of "an agreement to participate in an unlawful act." *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir. 1980); *Alfus v. Pyramid Technology Corp.*, 745 F.Supp. 1511, 1520 (N.D.Cal. 1990). Plaintiffs have not identified any evidence in the record demonstrating the existence of such an agreement, especially in light of Omnitrition's not falling within the *Nguyan* definition of a pyramid scheme. Moreover, defendants Jim Fobgir, Roger Daley, and Charles Ragus have each submitted declarations in which they maintain they did not enter into an agreement to deceive or mislead Omnitrition IMAs. (Fobair Decl. ¶ 8, Daley Decl. ¶ 8, Ragus Decl. ¶ 9)

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money through participating in Omnitrition.

[18] Plaintiff Robert Ligon insists that he lost money, but, tellingly, has yet to forward any evidence concerning the nature or extent of any such loss. (Burns Decl. Ex J, at 324).

F. Plaintiffs' Claims Pursuant to 18 U.S.C. §§ 1962(c) and (d) [RICO]

1. Whether Plaintiffs Have Proof to Support Their Allegations of Defendants' Engaging in RICO Predicate Acts

To be held liable under the RICO statute, defendants must have conducted the affairs of the enterprise "through a pattern of racketeering activity." 18 U.S.C. § 1962(c). To show this pattern, the RICO statute requires two or more predicate acts. 18 U.S.C. § 1961(5). Plaintiffs maintain that defendants engaged in mail fraud, wire fraud and securities fraud.

Mail fraud or wire fraud is demonstrated if plaintiffs can show that defendants 1) formed a scheme or artifice to defraud, 2) used the mails or wires in furtherance of the scheme, and 3) did so with the specific intent to deceive or defraud. *California Architectural Building Products*, 818 F.2d 1466, 1469 (9th Cir. 1987). However, the requirement of specific intent is met by showing the existence of a scheme that was reasonably intended to deceive the ordinary person, and this intention is determined by looking to the scheme itself. *United States v. Green*, 745 F.2d 1205, 1207 (9th Cir. 1984), *cert. denied*, 474 U.S. 925 (1985).

Plaintiffs maintain that since they have proven Omnitrition is a pyramid scheme, they need not prove specific intent. However, as previously discussed, plaintiffs have failed to demonstrate or otherwise establish a triable issue of fact concerning whether Omnitrition is a pyramid scheme. As there is otherwise no evidence of specific

intent on the part of the defendants to defraud anyone, plaintiffs' RICO claims are fatally deficient.

2. Whether There is a Legally Cognizable RICO Enterprise

Section 1962(c) allows private parties to file suit against "persons" associated with an "enterprise" who participate in the enterprise's affairs through a pattern of racketeering activity. *See* 18 U.S.C. § 1962(c). Under section 1962(c), RICO plaintiffs must allege the existence of a RICO enterprise that has "an ascertainable structure which is distinct from the racketeering activity itself." *Colegrove v. Price Waterhouse,* 1992 WL 435799 at 4 (N.D.Cal. 1992).

In their amended complaint, plaintiffs allege that Omnitrition was conceived and operated by defendants as an illegal pyramid scheme. (Amended Complaint., ¶ 31). Plaintiffs have failed to allege that the defendants have engaged in any activity separate and apart from the alleged pattern of racketeering acts in the course of the conduct of the enterprise, or that the participants joined Omnitrition for any purpose other than promoting Omnitrition's business activities.[19]

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[19] Plaintiffs maintain that defendants Gardere & Wynne and M. Douglas Adkins engaged in some legitimate activity while participating in Omnitrition; however, since they were not named in the association in fact, their actions are not relevant for consideration of this issue.

As plaintiffs have failed to identify a cognizable RICO enterprise, plaintiffs' § 1962(c) and (d) claims are also legally deficient.

G. Plaintiffs' State Claims

Plaintiffs allege claims for common law fraud and deceit, the elements of which are a misrepresentation of material fact, knowledge of falsity, intent to deceive, justifiable reliance, and resulting damage. *Cicone v. URS Corp.*, 183 Cal.App.3d 194, 200 (1986). Plaintiffs have provided no evidence as to any of these elements, most notably damages, reliance, intent to deceive, or a misrepresentation of fact.

Plaintiffs' remaining state law claims are for false advertising and unfair business practices. Both of these claims are premised on the allegation that the statements allegedly made by defendants were false and misleading. (Amended Complaint, ¶ 90, 92). As discussed in the analysis of plaintiffs' § 10(b) and § 12 claims, plaintiffs have failed to provide any evidence to support a finding that any statements made by defendants were false and misleading.

CONCLUSION

For the reasons stated above,

IT IS HEREBY ORDERED THAT

1. Defendants' motion for summary judgment is GRANTED.

2. Plaintiff's counter-motion for summary adjudication of certain issues is DENIED.

3. Defendant Jerry Rubin's unopposed joinder of defendants' motion for summary judgment is GRANTED.

IT IS SO ORDERED

DATED: July 25, 1994

/s/ Saundra Brown Armstrong
SAUNDRA BROWN
ARMSTRONG
United States
District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

IN RE OMNITRITION INTERNATIONAL, INC. SECURITIES LITIGATION	MDL No. 965 No. C 92-4133 SBA
THIS DOCUMENT RELATES TO:	JUDGMENT
WEBSTER V. OMNITRITION, et al. C-92-4133 SBA	(Filed Jul. 26, 1994)

Pursuant to an Order of this Court granting defendants Omnitrition International, Inc., Jim Fobair, Roger Daley and Charles Ragus' motion for summary judgment, which was joined by defendant Jerry Rubin,

IT IS HEREBY ORDERED that FINAL JUDGMENT be entered in favor of defendants Omnitrition International, Inc., Jim Fobair, Roger Daley, Charles Ragus, and Jerry Rubin.

IT IS SO ORDERED

DATED: July 25, 1994

/s/ Saundra B. Armstrong
SAUNDRA BROWN ARMSTRONG
United States
District Judge

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

U.S. Court of Appeals Docket Number: 94-16477
Lower Court Docket Number: CV-92-04133-SBA

SHAUN WEBSTER and ROBERT LIGON, on behalf of themselves and all others similarly situated,

Appellants/Respondents,

v.

OMNITRITION INTERNATIONAL, INC., JIM FOBAIR, ROGER DALEY, CHARLES RAGUS and JERRY RUBIN,

Appellees/Petitioners.

PETITION OF DEFENDANTS/APPELLEES OMNITRITION INTERNATIONAL, INC., JIM FOBAIR, ROGER DALEY AND CHARLES RAGUS FOR REHEARING AND SUGGESTION FOR REHEARING *EN BANC*

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TABLE OF CONTENTS

I. PETITION FOR REHEARING AND SUGGESTION FOR REHEARING, *EN BANC* 1

II. THE COURT IMPROPERLY SHIFTED THE RULE 56 BURDEN OF PRODUCTION 1

III. THE PANEL ERRED IN RELIEVING PLAINTIFFS OF THE BURDEN TO PRODUCE EVIDENCE ON THE *KOSCOT* ELEMENTS 6

The *Koscot* Elements and the Omnitrition Program 6

The Court's Mistakes Regarding "a Payment for the Right to Sell a Product" 7

The Court's Mistakes Regarding "Recruitment Rewards Unrelated to Sales of Products to Ultimate Users" 8

The Court misapprehends the "relation to sales" element of Koscot 8

Omnitrition's difference from Koscot in the relation test 9

The "Amway safeguards" assure that the second Koscot element is satisfied 11

IV. THE COURT HAS ERECTED A NEW LEGAL PRESUMPTION AGAINST MULTI-LEVEL COMPANIES 12

V. CONCLUSION 13

VI. PRAYER FOR RELIEF 13

TABLE OF AUTHORITIES

CASES: PAGE

Adickes v. Kress, 398 U.S. 144 (1970) 4, 5

Celotex Corp. v. Catrett, 477 U.S. 317 (1986) 2, 5

In re Amway Corp., 93 F.T.C. 618 (1979) 3, 4, 5, 11

Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975), *aff'd mem. sub nom. Turner v. F.T.C.*, 580 F.2d 701 (D.C. Cir. 1978) 2, 3, 4, 5, 6, 8, 9, 10, 11, 12

Musick v. Burke, 913 F.2d 1390 (9th Cir. 1990) 2

SEC v. W.J. Howey Co., 328 U.S. 293 (1945) 6

PETITION FOR REHEARING AND SUGGESTION FOR REHEARING *EN BANC*

Defendants/Appellees Omnitrition International, Inc., Jim Fobair, Roger Daley and Charles Ragus ("Petitioners" or "Omnitrition") request a rehearing of this appeal and suggest rehearing *en banc* because the published Opinion of March 4, 1996 creates a conflict within the Ninth Circuit Court of Appeals, and because the panel applied new and erroneous standards of law to multi-level merchandising organizations.

THE COURT IMPROPERLY SHIFTED THE RULE 56 BURDEN OF PRODUCTION

The question in this case is whether Omnitrition's multi-level sales organization is an unlawful pyramid scheme. In reversing summary judgment entered for Omnitrition below, this Court found that Omnitrition had not proven that its system is free of the telltale elements

of a pyramid scheme.[1] In doing so, the panel employed an improper standard of law for reviewing a summary judgment when it placed the Rule 56 burden of production upon Omnitrition, as movant. Under current summary judgment law, the burden is properly placed on non-movant Plaintiffs to produce evidence on each element of their claims, in this case on each element of the substantive legal test for an unlawful pyramid scheme.

The proper allocation of Rule 56 burdens of proof under current case law is this:

> Rule 56 mandates the entry of summary judgment . . . against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which the party will bear the burden of proof at trial.

Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). Moreover, this Circuit has held:

> . . . *Rule 56 places no evidentiary burden on a moving defendant* beyond that which is required for him to prevail at trial. Therefore, while it is incumbent upon *the adverse plaintiff to offer evidence sufficient* to raise a genuine issue of fact on an issue *on which the plaintiff has the burden of proof, the moving defendant need provide nothing more than a reference to those materials on file in the*

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[1] The panel found in fact that Omnitrition's structure is *"unquestionably not a pyramid scheme"* at the level of basic distribution, but that there is a triable issue whether a pyramid begins higher up at the supervisor level. *Opinion* at 2033. The named Plaintiffs are non-supervisor distributors who admit that they suffered no losses from participating in Omnitrition. *ER* 372.

case which support the movant's belief that there is an absence of any genuine issues of fact.

Musick v. Burke, 913 F.2d 1390, 1394 (9th Cir. 1990) (emphasis added). Accordingly, Omnitrition had no burden to produce *any* evidence on summary judgment.[2] Nevertheless the panel Opinion reversed summary judgment for Omnitrition because Omnitrition *did not prove* that it does not operate a pyramid scheme.

In its review, this Court adopted the substantive analysis articulated in the *Koscot* case[3], to determine whether the District Court erred in granting summary judgment. Petitioners agree with this legal standard. *Koscot* defines a test for identifying "pyramid schemes" that offend the antifraud provisions of the federal securities laws. Under this test, an illegal pyramid scheme is one that:

> (1) requires the payment of a fee for the right to sell a product; and
>
> (2) offers rewards for recruiting others into the program that are unrelated to the sale of products to the ultimate consumer.

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[2] In fact, as articulated by Chief Justice Rehnquist in the Supreme Court's 1986 summary judgment trilogy, a movant without the burden of proof at trial (like Omnitrition, a defendant-movant) only bears "the initial burden of informing the district court of the basis for its motion . . . " *Celotex v. Catrett*, 477 U.S. at 323. Moreover, that burden "may be discharged by showing – that is, pointing out to the district court – that there is an absence of evidence to support the nonmoving party's case." *Id.* at 325.

[3] *Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1181 (1975), *aff'd mem. sub nom. Turner v. F.T.C.*, 580 F.2d 701 (D.C. Cir. 1978).

Koscot, 86 F.T.C. at 1181. These elements constitute the substantive burden that Plaintiffs must bear to survive a motion for summary judgment. In order to defeat Omnitrition's Motion for Summary Judgment, *Plaintiffs* were obliged to produce evidence sufficient to raise a triable issue of fact on both of the *Koscot* elements.

In its Motion for Summary Judgment, Omnitrition invoked the administrative expertise of the Federal Trade Commission which found that the presence of certain anti-pyramiding procedures distinguished multi-level sales operations from pyramid schemes. According to the seminal opinion, the *Amway* case[4], a multi-level organization is safe from pyramiding charges if the company will buy back unsold merchandise, if participants are required to sell the greater part of their products before reordering, and if participants provide proof of retail sales. These "Amway safeguards"[5] assure that there is a relation between "recruitment rewards" and retail sales, and that the sales of products is the main business of a multi-level company. The FTC ruling in *Amway* established that there

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[4] *In re Amway Corp.*, 93 F.T.C. 618 (1979).

[5] The "Amway safeguards" in the Omnitrition program are modeled after Amway's. Omnitrition's procedures require that distributors sell 70% of products purchased before they are permitted to reorder; that they prove that they made retail sales to ten (10) different customers each month; and that Omnitrition will buy back its products from distributors at 90% of their prices within 12 months (three months for consumables). These rules are calculated to prevent inventory-loading and to encourage retail sales.

is nothing *per se* unlawful about multi-level sales organizations, nor any legal reason that multi-level companies ought to be presumed to be pyramid schemes.

The opinion of this Court, however, effectively imposed a presumption that Omnitrition is an unlawful pyramid scheme when it held that Omnitrition had the burden to produce evidence that the *Amway* safeguards actually work. The Court made this critical shift in the burden of production to Omnitrition by holding that:

> Where, as here, a distribution program *appears* to meet the *Koscot* definition of a pyramid scheme, *there must be evidence that the program's safeguards are enforced and actually serve to deter inventory loading and encourage retail sales.*

Opinion at 2036 (emphasis added). In doing so, the panel precisely reversed the proper Rule 56 burden of proof.

In order to prevail at trial, Plaintiffs must prove by a preponderance of evidence that the two *Koscot* factors are present in Omnitrition's program. Accordingly, under correct Rule 56 standards, Plaintiffs have the burden of producing some evidence on each of the two *Koscot* elements. In a complete perversion of settled summary judgment law, however, the panel Opinion held that Omnitrition's *prima facie* showing of Amway's safeguards fully in place (that is, that the *Koscot* elements are *not* present) is the basis for a *denial* of summary judgment.

Harkening back to the old summary judgment rule of *Adickes v. Kress*, 398 U.S. 144, 157 (1970), this Court reversed Omnitrition's summary judgment on the grounds that it, a *defendant-movant*, must foreclose that Plaintiffs *could* prevail at trial. *Adickes* has, of course, been

overruled by the standard enunciated in the *Celotex* case.[6] This Court's reversal, though, rested on the old *Adickes* premise when it held that the defendant-movant Omnitrition bore the burden of production on three critical issues:

> First, Omnitrition produced evidence of enforcement only for its ten customer rule. . . . That some amount of product was sold by each supervisor to only ten consumers each month does not insure that overrides are being paid as a result of actual retail sales.
>
> Second, Omnitrition produced no evidence of enforcement of its 70% rule. . . . There is no evidence that this "certification" requirement actually serves to deter inventory loading. . . .
>
> Third, Omnitrition has not shown that it enforces its buy-back rule, or the extent to which Omnitrition has actually repurchased product from disappointed [distributors].

Opinion at 2036-37. Consequently, the Court incorrectly ruled that:

> Our review of the record does not reveal sufficient evidence to establish as a matter of law that Omnitrition's rules *actually work.*

Opinion at 2036 (emphasis added). Unquestionably, though, under the controlling *Celotex* summary judgment standard, *Plaintiffs* properly have the burden to produce evidence that these anti-pyramiding rules *do not work.*[7]

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[6] *Celotex v. Catrett*, 477 U.S. at 323.

[7] Under the panel's summary judgment standard, Omnitrition is being punished for having *exceeded* its burden of

Rehearing or rehearing *en banc* should be granted to correct the panel Opinion's erroneous application of summary judgment law. The Opinion contradicts both controlling Supreme Court precedent and the settled law of this Circuit.

THE PANEL ERRED IN RELIEVING PLAINTIFFS OF THE BURDEN TO PRODUCE EVIDENCE ON THE *KOSCOT* ELEMENTS

The *Koscot* Elements and the Omnitrition Program

Under proper summary judgment standards in this case, Plaintiffs must show the existence of material facts in dispute regarding both *Koscot* factors – rather than being allowed to rest on a presumption of unlawfulness. Plaintiffs must produce evidence both of payments of fees for the right to sell products and rewards, unrelated to retail sales, based on recruitment of new supervisors.[8]

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production. Petitioner's proof, in its prima facie case that Omnitrition's program was modeled on the FTC-approved *Amway* model, serves only to confirm the propriety of the district court's entry of summary judgment. Omnitrition's proof does not relieve the Plaintiffs-non-movants from their intermediate burden of adducing evidence on the two critical *Koscot* factors that are indispensable to proving an unlawful pyramid scheme.

[8] The reasoning underlying *Koscot* is that payments made for an intangible right to participate in a sales program, together with rewards for inducing others to pay for the same intangible right, are a "security," and specifically an "investment contract," under the test set forth in the *Howey* case. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1945).

The "pyramidal" nature of the *Koscot* scheme inheres in the fact that program rewards came from a participant's ability, once he had paid a large fee for the privilege, to recruit more numbers of new participants, sharing in *their* fees for participation, who would in turn recruit additional numbers of new recruits, also paying new fees shared by the original recruiter, "head-hunting" *ad infinitum*, a scenario that the *Koscot* Court held "inherently fraudulent."

By contrast, Omnitrition produced evidence that it charges no fees for the right to participate in its program or to purchase or sell its products. *ER* 371 ¶ 5, 6. Supervisors purchase Omnitrition *products* (as opposed to the intangible right to participate in the program) at a discount from retail prices, the discount increasing with the volume of purchases. Volume discounts are not themselves pernicious, nor are they "unrelated to retail sales". In fact, an Omnitrition supervisor who buys the products at a discount can earn commissions *only* by reselling them at a "discount profit" or "wholesale profit." There is a second way that a supervisor can profit: by building a distribution network, with resulting orders from a network of supervisors ("downlines") at a volume sufficient to earn "royalty overrides" and "bonuses," ranging from 1% to 4% on those supervisors' orders. But there is *no* personal minimum purchase requirement for a supervisor to earn *any income*.

The Court's Mistakes Regarding "a Payment for the Right to Sell a Product"

This Court reversed by making this finding, however, for which there is no evidence: that the purchases of products are the equivalent of the payment of a fee to participate. *Opinion* at 2033. The Court confuses the two separate and distinct ways that a Omnitrition supervisor can make money:

(i) "Commissions" from re-selling products bought at discounts; and

(ii) "Overrides" or "bonuses" on their "down-lines" sales volume.

"Commissions" earned from a supervisor's own sales, have nothing to do with "recruitment rewards," which are the overrides/bonuses. Because the overrides/bonuses are not based on the supervisor's own purchases, or contingent upon them in any way, those purchases are not the same as payment for the right participate.

The Court reveals its mistake when it finds,

- "To become a supervisor, a participant must pay a substantial amount of money to Omnitrition in the form of large monthly product orders."

- "Supervisors and those they recruit must continue to purchase a minimum amount of products each month from Omnitrition to qualify the supervisor for commissions."

Opinion at 2033-34, 2030. *These key fact-findings are wrong.*

To the contrary, the only summary judgment evidence on this point confirms that *"[t]here is no sales volume requirement to maintain the status of an IMA."* *ER* 371 (Omnitrition Handbook p.9). Quite simply, no distributor is *required* to become a supervisor, or to purchase any minimum amount in order to remain a supervisor. *ER* 372; *ER* 371, Ex 10, 11, 12.

The Court's Mistakes Regarding "Recruitment Rewards Unrelated to Sales of Products to Ultimate Users"

The Court misapprehends the "relation to sales" element of Koscot

The Court holds, under its improper summary judgment standard, that Omnitrition fails the second prong of the *Koscot* test in that the program includes, it says, rewards for recruitment that are unrelated to retail sales. Plaintiffs have not produced *any* evidence that they were offered or paid any "recruitment rewards unrelated to sales." The Court overlooks, as well, the evidence showing that Omnitrition has never paid any "head-hunting" fees or rewards for recruiting *per se*. *ER* 371 ¶ 8. There is, in fact, abundant evidence of a *relationship* between what the Court calls "recruitment rewards" (a mischaracterization, in any case), and ultimate, or retail sales.

On its way to erecting a new legal presumption, the Court imposes a new requirement in this case, one not found in *Koscot*, that the relationship between recruitment rewards and retail sales must be such that *incentives* for building wider distributor networks (in this case, in the form of overrides on a supervisor's downline's orders) *be*

based upon if not actually calculated directly from, actual retail sales. This new rule would illegalize multi-level merchandising as practiced by many legitimate businesses, including the now-venerable Amway itself.

These multi-level organizations seek to create incentives for these independent contractors to build wider networks for distribution – that is *sales* – of their products. These are not the "galactic profits" promised by the *Koscot* pyramiders for recruiting. Instead, they are earned incentives economically- related to the sales efforts of the supervisors' downline. They should be contrasted with, not equated to, *Koscot's* objectionable "head-hunting" fees.

Omnitrition's difference from Koscot in the relation test

Omnitrition's discount profits and overrides are thus not "recruitment rewards" as Koscot articulated them, at all. In *Koscot,* participants paid a fee, either $1000 or $5000, for the right to participate in the selling program, for the right to purchase products at a discount and for the right to resell them. In addition, they were offered "head-hunting fees," – outright payments for inducing others into the program – regardless of *any* product sales. In *Koscot,* there was absolutely *no* relation between these "recruitment rewards" and sales. This Court loses sight of the fact that the evil in *Koscot* was the "pyramiding" of the sales of these nebulous "rights" to participate in a scheme consisting of the sales of yet *more* nebulous rights. In comparison, such "rewards" as there are in Omnitrition are never based on mere recruitment, and never involve a fee for mere recruitment, but are the result of

product orders from supervisors who become a part of another supervisor's downline.

The Court's conclusion that the second *Koscot* element can be defeated only when rewards for recruitment are *tied* "to actual retails sales" goes too far. This Court, in extending *Koscot*, requires virtually a commission structure, and in effect prohibits incentives for building an independent wholesale-level distributorship. *Koscot* sought to prevent the pyramiding of the recruitment rewards *themselves*, but this Court extends and enlarges the *Koscot* elements effectively to prohibit multi-level distribution except on the basis of commissioned retail sales.

The Court, caught up in its analysis of the "appearance" of a pyramid, overlooks that it was Plaintiffs' burden, which they have not met, to produce some evidence of what they must prove at trial:

(i) that they paid for the right to sell Omnitrition products;

(ii) that they were promised or received recruiting rewards unrelated to retail sales; and

(iii) that participating in Omnitrition's program caused them injury.

At trial, Plaintiffs cannot rest upon a mere appearance, but must produce *evidence*, and this Court incorrectly excused them from the burden of producing some now. Requiring Plaintiffs to produce such evidence would show that Omnitrition bears no resemblance, even "on its face," to Koscot Interplanetary, Inc.

The "Amway safeguards" assure that the second Koscot element is satisfied

On summary judgment, the District Court found that the Amway safeguards assure that the *aim* of the Omnitrition program, including its incentives for network-building, is to sell its *products*, not nebulous rights to participate in a scheme designed to sell more nebulous rights, as in *Koscot*. The Amway safeguards are, just as they are in Amway itself, additional insurance against the second *Koscot* element, so that "recruitment rewards" are not the object of a supervisors' efforts, except as they produce retail sales.

Plaintiffs did not produce any evidence that these safeguards are not working. Such evidence would be, for example, that they had gotten "stuck" with large amounts of unsalable and non-returnable inventory. In fact, Plaintiffs specifically admitted that they had not. *ER* 372, Ex N; *ER* 372, Ex J. *The Court overlooks that these admissions are either evidence that the Amway safeguards "actually work" or that the incentives are not the cause of the injury.* In any event, it is properly Plaintiffs' burden to show loss causation from the so-called "recruitment rewards" or from the failure of the Amway safeguards – not Omnitrition's to show that they "work" and prevent injury that has not been shown to have occurred.

THE COURT HAS ERECTED A NEW LEGAL PRESUMPTION AGAINST MULTI-LEVEL COMPANIES

In placing the burden of production on Omnitrition in this case, and by extending the *Koscot* principles to

impose new requirements for evaluating sales incentives, the Court has, perhaps unwittingly, created a new legal presumption that will likely have devastating effects upon many now-thriving businesses in several industries that use a multi-level merchandising approach. The Court, *en banc,* should be mindful of the implications here: that a "facial" case of pyramiding, under the substantive and procedural principles articulated in the panel Opinion, would put Amway[9] itself to trial, today, as well as established companies like Mary Kay and Herbalife. Substantively, the panel's insistence that the *Koscot* "relation test" means that incentives to *wholesale* purchasers must be calculated on the basis of ultimate *retail* sales, would transform multi-level merchandising organizations into conventional vertically-integrated corporate entities employing commissioned sales agents, instead of today's thriving networks of independent business people engaged in building their own enterprises to levels which suit their individual needs. Neither the securities laws nor federal or state antifraud regulations – as the happy history of Amway for the last 30 years demonstrates – requires such a result.

CONCLUSION

The three-judge panel that heard this appeal employed the wrong standard for the burden of proof for summary judgment. Its rulings conflict with other Ninth

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[9] In fact, the Court admits as much when it makes this comment: "The same logical criticism could be made of Amway's ten customer rule." *Opinion* at 2036. Indeed, *res judicata* issues aside, this Court would put Amway to trial today.

Circuit cases, and fly in the face of settled United States Supreme Court precedent. The summary judgment standard it uses, moreover, establishes a new substantive rule of law amounting to a presumption of illegality of multi-level companies. These errors of procedure and substance should be corrected by this Court on rehearing, *en banc.*

PRAYER FOR RELIEF

Petitioners request that the Court rehear this appeal, and suggest that it should be heard *en banc,* and upon rehearing, to vacate the Court's published Opinion of March 4, 1996, and affirm the summary judgment of the District Court in favor of Petitioners.

DATED: March 18, 1996.

WILLIAM CHRISTOPHER CARMODY P.C.

By: /s/ William Christopher Carmody
William Christopher Carmody

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ATTORNEYS FOR PETITIONERS
OMNITRITION INTERNATIONAL, INC.,
ROGER M. DALEY, JAMES FOBAIR AND
CHARLES RAGUS

STATEMENT OF RELATED CASE

This appeal is related to one other appeal arising out of the underlying consolidated actions: Court of Appeal Docket No. 94-16478.

DATED: March 18, 1996.

WILLIAM CHRISTOPHER CARMODY P.C.

By: /s/ William Christopher Carmody
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ATTORNEYS FOR PETITIONERS OMNITRITION INTERNATIONAL, INC., ROGER M. DALEY, JAMES FOBAIR AND CHARLES RAGUS

PROOF OF SERVICE

STATE OF TEXAS, COUNTY OF DALLAS

I am employed in the County of Dallas, State of Texas. I am over the age of 18 and not a party of the within action; my business address is 4950W Texas Commerce Tower, 2200 Ross Avenue, Dallas, Texas 75201.

On March 18, 1996, I served the foregoing document described as PETITION OF DEFENDANTS/APPELLEES OMNITRITION INTERNATIONAL, INC., JIM FOBAIR,

ROGER DALEY AND CHARLES RAGUS FOR REHEARING AND SUGGESTION FOR REHEARING *EN BANC* ***on all interested parties*** in this action

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/s/ William Christopher Carmody
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NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SHAUN WEBSTER and ROBERT LIGON, Plaintiffs-Appellants, v. OMNITRITION INTERNATIONAL, INC.; JIM FOBAIR; ROGER DALEY; CHARLES RAGUS; JERRY RUBIN, Defendants-Appellees.	No. 94-16478 D.C. No. CV-92-04133-SBA ORDER (Filed Apr. 18, 1996)

Before: CHOY, BEEZER and HAWKINS, Circuit Judges

Upon due consideration, the petition for rehearing by appellees M. Douglas Adkins and Gardere & Ynee, filed on March 15, 1996 is DENIED.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SHAUN WEBSTER and ROBERT LIGON, Plaintiffs-Appellants, v. OMNITRITION INTERNATIONAL, INC.; JIM FOBAIR; ROGER DALEY; CHARLES RAGUS; JERRY RUBIN, Defendants-Appellees.	No. 94-16478 D.C. No. CV-92-04133-SBA ORDER (Filed Apr. 30, 1996)

Before: CHOY, BEEZER and THOMPSON, Circuit Judges

The motion filed April 18, 1996 in the above matter denying the petition for rehearing by appellees Adkins and Gardene & Wynne is amended to correct the panel. The panel in the above matter is CHOY, BEEZER and THOMPSON.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SHAUN WEBSTER and ROBERT LIGON, Plaintiffs-Appellants, v. OMNITRITION INTERNATIONAL, INC.; JIM FOBAIR; ROGER DALEY; CHARLES RAGUS; JERRY RUBIN, Defendants-Appellees.	No. 94-16477 D.C. No. CV-92-04133-SBA ORDER (Filed Apr. 23, 1996)

Before: CHOY, BEEZER and HAWKINS, Circuit Judges

The panel has voted unanimously to deny the petition for rehearing. Judges Beezer and Hawkins vote to reject the suggestion for rehearing en banc and Judge Choy so recommends.

The full court has been advised of the suggestion for rehearing en banc and no judge in active service has requested a vote to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SHAUN WEBSTER and ROBERT LIGON, Plaintiffs-Appellants, v. OMNITRITION INTERNATIONAL, INC.; JIM FOBAIR; ROGER DALEY; CHARLES RAGUS; JERRY RUBIN, Defendants-Appellees.	No. 94-16477 D.C. No. CV-92-04133-SBA ORDER (Filed Apr. 30, 1996)

Before: CHOY, BEEZER and THOMPSON, Circuit Judges

The motion filed April 16, 1996 in the above matter denying the the filing of the amicus brief in support of the petition for rehearing and suggestion for rehearing en banc and the motion filed on April 23, 1996 denying the petition for rehearing and rejecting the suggestion for rehearing en banc are amended to correct the panel. The panel in the above matter is CHOY, BEEZER and THOMPSON.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

SHAUN WEBSTER and ROBERT LIGON, Plaintiffs-Appellants, v. OMNITRITION INTERNATIONAL, INC.; JIM FOBAIR; ROGER DALEY; CHARLES RAGUS; JERRY RUBIN, Defendants-Appellees.	No. 94-16477 D.C. No. CV-92-04133-SBA AMENDED ORDER (Filed May 8, 1996)

Before: CHOY, BEEZER and THOMPSON, Circuit Judges

The order filed April 30, 1996 in the above matter is amended to change the word "motion" to "order."

IN THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

U.S. Court of Appeals Docket Number: 94-16477
Lower Court Docket Number: CV-92-04133-SBA

SHAUN WEBSTER and ROBERT LIGON, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellants,

v.

OMNITRITION INTERNATIONAL INC., JIM FOBAIR, ROGER DALEY, CHARLES RAGUS, and JERRY RUBIN,
Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of California
No. CV-92-04133-SBA

MOTION OF DIRECT SELLING ASSOCIATION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITION FOR REHEARING AND SUGGESTION OF REHEARING EN BANC

Pursuant to Rule 29 of the Federal Rules of Appellate Procedures, the Direct Selling Association ("DSA" or "the Association") hereby moves for leave to file the accompanying brief *amicus curiae* in support of Omnitrition's petition for rehearing and suggestion of rehearing en banc. Counsel for *amicus curiae* requested the consent of the parties to the filing of the brief. Counsel for appellees have consented, but counsel for appellants has declined

to do so, necessitating this motion. In accordance with Rule 29, the brief *amicus curiae* is being conditionally filed along with this motion.[1]

The Association is a national trade association headquartered in Washington, D.C. It represents companies that distribute products to customers through independent salespersons who personally demonstrate and explain the products to the consumer, usually in the home or work place. DSA's membership of 146 companies accounts for more than 90% of the industry's annual sales volume. Direct sellers are perhaps best known to the public as person-to-person, door-to-door, or home party plan sellers. Through such sales efforts, direct selling companies (often small or new) are able to provide quality goods and services to consumers without having to overcome the substantial advertising expenditures and other barriers that accompany more traditional distribution systems.

Over 70% of DSA members classify themselves as multilevel marketing companies, a means of organizing a direct selling business in which customers are offered the opportunity to share with others their enthusiasm for a

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[1] This Court has entertained briefs of *amici curiae* in support of petitions for rehearing in other cases *See, e.g., United States v. Chavez-Vernanza*, 844 F.2d 1368, 1372 n.2 (9th Cir. 1987) ("In his brief in support of Chavez's petition for rehearing and suggestion for rehearing en banc, amicus argues that * * * ."). *See also, Bratton v. City of Detroit*, 712 F.2d 222, 223 n.1 (6th Cir. 1983) (referring to request of the United States to file brief *amicus curiae* in support of petition for rehearing en banc; issue moot because rehearing was denied prior to receipt of request), *cert. denied*, 464 U.S. 1040 (1984).

product and to receive rewards from sales to those customers and to those who they may in turn introduce to the company. In 1994, over 6.3 million individuals sold directly, generating over $16.55 billion in estimated retail sales. Of this group, 73.6% are women, 12.5% are African Americans, 1% are Asian Americans, and .5% are Native Americans. In addition, 8% of direct salespeople have a physical disability, and 4.5% are over 65 years of age.

Over many years, DSA has worked toward the development of clear and reasonable standards which have been used by law enforcement officials, legitimate businesses, and the public to distinguish illegal and fraudulent pyramid schemes from bona fide direct selling companies.[2] In this case, a panel of the Court used language which could inadvertently call into question aspects of many legitimate companies' marketing and compensation plans, as well as long-established features and safeguards which distinguish bona fide marketing plans from pyramid schemes.

DSA believes it is vital that the Court, as it considers rehearing and rehearing en banc, have a full and complete understanding of the current, accepted business practices of legitimate direct selling companies, as well as the proven effectiveness of the pertinent features and safeguards in assisting distributors and the public to

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[2] DSA has participated in earlier litigation as an amicus. *See, e.g., State ex rel. Miller v. American Professional Marketing, Inc.*, 382 N.W.2d 117 (Iowa, 1986) *Ger-Ro-Mar, Inc.*, 84 F.T.C. 95 (1974) (amicus br. of DSA). Additionally, DSA has been a defendant in a law suit brought by an established pyramid scheme for not allowing that pyramid into DSA membership.

distinguish between pyramid frauds and legitimate opportunities. While DSA takes no position regarding the enforcement of similar rules by Omnitrition or any other factual matters presented to the Court, this Court should have the benefit of the views of direct sellers who support and enforce effective and recognized safeguards.[3]

This case is of considerable importance to the Association and its members. The Association's arguments are substantial ones that the Court should have before it in considering rehearing, but they are ones that might be overlooked in the absence of *amicus* participation. In short, the role the Association seeks in this case is what this Court has described as the "classic role of amicus curiae" – "assisting in a case of general public interest, supplementing the efforts of counsel, and drawing the court's attention to law that escaped consideration." *Miller-Wohl Co., Inc. v. Commission of Labor and Industry*, 694 F.2d 203, 204 (9th Cir. 1982).

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[3] The brief is being filed with this motion as expeditiously as possible after the Association learned of the petition for rehearing and suggestion for rehearing en banc. Federal Rule of Appellate Procedure 29 contemplates that the Court may, upon granting leave to file, permit an opposing party with an opportunity to answer the amicus brief. The brief complies with the page limits for a petition for rehearing.

CONCLUSION

For the foregoing reasons, the Association's motion for leave to file a brief *amicus curiae* should be granted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that two copies of the foregoing MOTION OF DIRECT SELLING ASSOCIATION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITION FOR REHEARING AND SUGGESTION OF REHEARING EN BANC were sent by regular U.S. mail this 2d day of APRIL, 1996, to:

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

U.S. Court of Appeals Docket Number: 94-16477
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SHAUN WEBSTER and ROBERT LIGON, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

OMNITRITION INTERNATIONAL, INC., JIM FOBAIR, ROGER DALEY, CHARLES RAGUS and JERRY RUBIN

Defendants-Appellees.

BRIEF OF *AMICUS CURIAE* DIRECT SELLING ASSOCIATION IN SUPPORT OF PETITION FOR REHEARING AND SUGGESTION OF REHEARING EN BANC

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IN THE
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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

STATEMENT OF INTEREST OF *AMICUS CURIAE*.. 1

ARGUMENT 4

I. THE COURT ERRS IN SUGGESTING THAT, *PRIMA FACIE* A MULTILEVEL MARKETING PLAN THAT CALCULATES COMPENSATION BASED ON PRODUCT ORDERS COULD BE A PYRAMID SCHEME WITHOUT REGARD TO THE EXISTENCE AND EFFECTIVENESS OF AN INVENTORY REPURCHASE POLICY AND OTHER DISTINGUISHING FEATURES..... 4

II. PERSONAL USE OF THE PRODUCTS BY PLAN PARTICIPANTS IS AN IMPORTANT FACET OF MULTILELVEL MARKETING 11

CONCLUSION 14

TABLE OF AUTHORITIES

Cases **Page**

In re Amway Corp., 93 F.T.C. 618 (1979) 4, 6, 7, 8, 9, 10, 11, 13, 14, 15

In re Ger-Ro-Mar, Inc., 84 F.T.C. 95 (1974) *rev'd.* 518 F.2d 33 (2d Cir. 1975)..... 3, 5, 6

Holiday Magic, Inc., 84 F.T.C. 748 (1974) 5, 6

Koscot Interplanatary, Inc., 86 F.T.C. 1106 (1979) *aff'd mem. sub nom. Turner v. F.T.C.*, 580 F2d 701 (D.C. Cir. 1978).....5, 6, 7, 10, 11, 12, 13

State ex rel. Miller v. American Professional Marketing, Inc., 382 N.W. 2d 117 (Iowa 1986) 3, 6

Webster v. Omnitrition, 96 Daily Journal D.A.R. 2427 .....3, 4, 5, 11

Statutes

15 U.S.C. § 45 5

Ga. Code Ann. § 10-1-415 8

La. Admin. Code tit. 16 § III.503 8

Md. Code Ann. Bus. Reg. § 14-302 8

Mass. Ann. Laws ch. 93 § 69 (Law. Co-op.) 8

Okla. Stat. Ann., tit. 21 § 1072 .....8, 13

Tex. Bus. & Com. § 17.46(b) 8, 13

Wyo. Stat. § 40-3-106 8

P.R. Laws Ann. tit. 10, § 997 8

Foreign Statutes

Competition Act, R.S.C. § 55 (1992) (Canada) 9

C. Comsumption Art. L. 122-6, 1995 (France) 9

Fair Trading Act, 1973, ch. 41 (England) .....

Pyramid Selling Schemes Regulation, 1990, (SI 1989, No. 2195) (England) 9

Ministere de L'Economie et des Finances, Direction Générale de la Concurrance, de la Consommation et de la Répression des Fraudes, Internal Note No. 6204, 18 Oct. 1995 (France) 9

Law on Retail Trade of 1996, ch. 22, 23 (Spain) 9

Miscellaneous

Mario Brossi & Joseph N. Mariano, *Multilevel Marketing – A Legal Primer* (1991) 3

Code of Ethics, Direct Selling Association §§ A.5-6 8

1992 Direct Selling Association Survey of Direct Sellers 12, 13

1995 Direct Selling Industry-Wide Growth and Outlook Survey Report 1, 2, 12, 13

Robert A. Peterson, et al., "Research Note: Consumers Who Buy From Direct Sales Companies," 65 *J. of Retailing* (Summer 1989) 13

"Promises. Check 'em Out!: Business Opportunity Fraud" (1994) 3

"Pyramid Schemes: Not What They Seem" (1991) 3

Special Issue on Direct Selling, in J. of Marketing Channels (Bert Rosenbloom ed., Feb. 1993) 13

World Codes of Conduct (Towards Direct Sellers, Between Direct Sellers, and Between Companies), World Federation of Direct Selling Associations § B.g 9

Thomas R. Wotruba, Direct Selling Education Foundation, *Moral Suasion, Development of the US Direct Selling Association Industry Code of Ethics* (1995) 13

Wotruba, "Full-time vs. Part-Time Salespeople – A Comparison on Job Satisfaction, Performance and Turnover in Direct Selling," *Int'l. J. of Research in Marketing*, Issue 7 (1990) 13

Wotruba, "The Effect of Goal-Setting on the Performance of Independent Sales Agents in Direct Selling," IX *The J. of Personal Sales & Sales Mgm't*, (Spring 1990) 13

STATEMENT OF INTEREST OF *AMICUS CURIAE*

The Direct Selling Association (DSA) is a national trade association headquartered in Washington, D.C. It represents companies which distribute products to customers through independent salespersons who personally demonstrate and explain the products to the consumer, usually in the home or work place. Direct sellers are perhaps best known to the public as person-to-person, door-to-door, or home party plan sellers. Direct selling provides an alternative distribution methodology by which companies (often small or new) may offer quality products and services to consumers without having to overcome the substantial advertising expenditures and other barriers to entry through more traditional distribution systems. Direct selling enables direct selling companies to overcome these barriers through the efforts of direct salespersons who provide personal demonstration, home delivery and a variety of other services which are not available in most retail outlets today. In 1994, over 6.3 million individuals sold directly, generating over $16.55 billion in estimated retail sales value.[1] We estimate that DSA's membership of 146 companies accounts for more than 90% of the industry's annual sales volume. At least 10 members of DSA are publicly traded companies.

Over 70% of DSA members classify themselves as multilevel marketing companies.[2] Multilevel marketing is a way of organizing a direct selling business in which customers are offered the opportunity to share with

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[1] 1995 Direct Selling Industry-Wide Growth and Outlook Survey.

[2] *Id.*

others their enthusiasm for a product and to receive rewards from sales to those consumers and from sales of and to those who they may in turn introduce to the company. Most of our salespeople and distributors use direct selling as a second, third, even fourth source of income. 76.3% of direct salespeople are female, 12.5% are African Americans, 4.7% are Hispanic Americans, 1% are Asian Americans and .5% are Native Americans. 8% of direct salespeople have a physical disability and 4.5% are over 65 years of age.[3] There are fundamentally six types of salespeople in direct selling. Many people become involved in direct selling to buy products they like at wholesale or discount prices. These *wholesale or discount buyers* can make up a significant portion of a direct selling company's customer and distributor base. Others join our companies to fulfill personal *short-term objectives* (e.g., working in December to earn holiday gift money.) The ease of entry into and exit from our business facilitates this type of sales activity. Others use our industry as a year round supplemental income source, but only work a few hours per week. Their extra direct selling income improves *the quality of their lives,* often keeping them in the middle class. Some direct sellers pursue their businesses as *careers,* devoting 30 hours or more per week to the business. Yet other individuals start direct selling businesses to gain *social contacts or recognition* otherwise missing in their lives. Finally, many direct sellers so *believe in their products* that they are driven to share them with family, friends and neighbors. People can move in

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[3] *Id.*

and out of these categories and can be in more than one category simultaneously.

DSA is vitally interested in the proceedings of this case and the decision of the Court in this matter. Over many years, DSA has worked toward the development of clear and reasonable standards which have been used by law enforcement officials, legislators, legitimate businesses, and the public, to distinguish pyramid schemes from bona fide direct selling companies.[4] DSA submits this brief as part of its ongoing effort to ensure that illegal pyramids are identified and prosecuted, and that the public continues to receive the benefits of the products and services of bona fide marketing companies.[5]

The Court asserts that the central issue "is whether Omnitrition's marketing program is a pyramid scheme."

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[4] DSA has participated in earlier relevant litigation as an amicus. *See, e.g., State ex rel. Miller v. American Professional Marketing, Inc.*, 382 N.W.2d 117 (Iowa, 1986); *In re Ger-Ro-Mar, Inc.*, 84 F.T.C. 95 (1974) (amicus br. of DSA). Additionally, DSA has been a defendant in a law suit brought by an established pyramid scheme for not allowing that pyramid into DSA membership.

[5] DSA and its Foundation have co-authored many publications with the cooperation of law enforcement and other public and quasi-public agencies for purposes of educating the public on the differences between pyramid schemes and multilevel companies. *See, e.g.*, "Pyramid Schemes: Not What They Seem" (1991) (published in cooperation with the Federal Trade Commission and the National District Attorneys Association). "Promises. Check 'em Out!: Business Opportunity Fraud" (1994) (published in cooperation with the National District Attorneys Association). *See, also,* Mario Brossi & Joseph N. Mariano. *Multilevel Marketing – A Legal Primer* (1991).

Webster v. Omnitrition, 96 Daily Journal D.A.R. 2427, at 2428. In resolving that issue as to Omnitrition, the Court uses broad statements concerning the types of rules (i.e., the company's inventory buyback obligation, the "ten-customer rule", and the "70% rule", discussed *infra*) relied upon by DSA members to clearly distinguish themselves from pyramid schemes.[6]

The Court's discussion of the efficacy of those rules and the legality of compensation paid on the basis of the purchases by recruits is troubling because it could inadvertently and inappropriately call into question aspects of many legitimate companies' marketing and compensation plans, as well as long-established consumer protection safeguards. DSA believes it is vital that the Court have a full and complete understanding of the current, accepted business practices of direct selling companies, as well as the pertinent safeguards which assist distributors and the public in their efforts to distinguish between pyramid frauds and legitimate opportunities. DSA is gravely concerned that, in determining that the summary judgment was premature and that the Omnitrition sales plan did not satisfy the standards set out in *In re Amway*, 93 F.T.C. 618 (1979), the Court may have inadvertently misapplied *Amway* and made statements which would cast doubt on the legality of some essential aspects of bona fide marketing plans. DSA takes no position, however, regarding the enforcement or effectiveness of similar rules adopted by Omnitrition or any other factual matters presented to the Court.

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[6] For purposes of this brief, DSA adopts Omnitrition's statement of the case and facts.

I. THE COURT ERRS IN SUGGESTING THAT, *PRIMA FACIE*, A MULTILEVEL MARKETING PLAN THAT CALCULATES COMPENSATION BASED ON PRODUCT ORDERS COULD BE A PYRAMID SCHEME WITHOUT REGARD TO THE EXISTENCE AND EFFECTIVENESS OF AN INVENTORY REPURCHASE POLICY AND OTHER DISTINGUISHING FEATURES.

In its initial analysis of the Omnitrition plan, the Court suggests that a multilevel marketing plan which offers compensation based on a participant's product orders could, on its face, be a pyramid scheme which rewards recruitment rather than retailing.[7] Whatever merit such a suggestion may (or may not) have regarding the Omnitrition plan, there is no judicial precedent and no basis in fact for such a broad pronouncement as to other plans which are not before the Court. The Court erred in suggesting that compensation based on product orders is necessarily unrelated to the sale of product to ultimate users and thus, *prima facie*, indicative of a pyramid scheme.[8] Bona fide marketing plans almost invariably

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[7] " . . . the [Omnitrition] supervisor receives the right to sell the products and earn compensation based on product orders made by the supervisor's recruits. This compensation is facially 'unrelated to sale of product to ultimate users' because it is paid on the suggested retail price of the amount ordered from Omnitrition, rather than based on actual sales to ultimate consumers . . . Omnitrition's program appears to be a pyramid scheme . . . [t]he mere structure of the scheme suggests that Omnitrition's focus was in promoting the program rather than selling the product." *Webster*, 96 Daily Journal at 2429.

[8] We attempt to make no assessment of the evidence produced by the parties regarding whether, in fact,

award compensation in a manner similar or identical to that described by the Court, thereby lawfully providing incentives for participants to recruit others to sell products to consumers. While these incentives are measured initially based upon the purchases made by recruits of the participant, they are made effectively contingent upon sales to ultimate consumers taking place by adoption and enforcement of rules which, together, encourage these sales and prevent inventory loading. If sales to ultimate consumers have not taken place, or if participants or recruits otherwise find themselves with inventory they cannot or do not wish to resell, they may return the goods to the company and receive back substantially the same price they paid, less any compensation previously paid on the unsold goods.

In analyzing the propriety of defendant's marketing plan, the Court relies upon the elements of a pyramid scheme as set out in *Koscot Interplanetary Inc.*, 86 F.T.C. 1106 (1975), which found that such schemes are inherently deceptive and in contravention of § 5 of the Federal Trade Commission Act, 15 U.S.C. § 45.[9] *See also, In re Ger-Ro-Mar, Inc.*, 84 F.T.C. 95 (1974), *rev'd* 518 F.2d 33 (2d Cir. 1974), *Holiday Magic Inc.*, 84 F.T.C. 748 (1974). The FTC's decisions in *Koscot*, etc. provided a broad definition of unlawful pyramid schemes; the Commission's basic test was that a pyramid rewards recruiting alone "unrelated to the sale of product to ultimate users" through head-hunting fees and inventory loading. However, violations

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compensation was awarded by Omnitrition on the basis of mere recruitment or product sales to ultimate user.

[9] *Webster*, 96 Daily Journal at 2428.

of the *Koscot* standard must be determined using an analysis of whether or not sales of products to ultimate users are taking place and driving the compensation mechanism, and in light of what features exist in the plan to prevent the evils of a pyramid scheme. After *Koscot*, the FTC refined its general analysis in *Amway*, which has served as the standard for distinguishing bona fide marketing plans from illegal pyramids for nearly twenty years. Many direct selling companies and law enforcement officials have relied on the tests established in *Amway*.

In *Amway*, distributors were eligible to receive a monthly bonus which was based on the total amount of products purchased for resale both to consumers and to other distributors. The FTC looked to several features of the Amway marketing plan to determine the legality of such compensation and incentives:

> The *Koscot*, *Ger-Ro-Mar*, and *Holiday Magic* cases all involved "marketing" plans which required a person seeking to become a distributor to pay a large sum of money, either as an entry fee (usually called a "headhunting" fee) or for the purchase of a large amount of *nonreturnable* inventory (a practice known as "inventory loading") (emphasis added). In exchange, the new distributor obtained the right to recruit others who would themselves have to pay a large sum of money – some of which would go to the recruiting distributor – to join the organization.
>
> By contrast, a person is not required to pay a headhunting fee or buy a large amount of inventory to become an Amway distributor . . . thus a sponsoring distributor receives nothing from the

> mere act of sponsoring. It is only when the newly recruited distributor begins to make wholesale purchases from his sponsor and sales to consumers, that the sponsor begins to earn money from his recruits' efforts. And Amway has prevented inventory loading at this point with its "buyback rule" which states that a sponsoring distributor shall "[p]urchase back from any of his personally sponsored distributors leaving the business, upon his request, any unused, currently marketable products . . . " *Amway*, 93 F.T.C. at 715-716.

The *Koscot* and *Amway* analyses, together, have set clear standards for determination of whether a plan is a pyramid scheme or a bona fide marketing plan. *See e.g., State ex rel. Miller v. American Professional Marketing, Inc.*, 382 N.W.2d 117 (Iowa, 1986).[10] A pyramid – in which participants pay for the right to sell a product and receive rewards which are unrelated to sale of products to ultimate users in return for recruiting other participants into the program – is typified by headhunting fees, large up-front payments and inventory loading. A bona fide marketing plan offers significant distinguishing features, like those considered in *Amway*. Chief among these features is that no fee or compensation is paid merely for having recruited additional participants; no large, non-returnable

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[10] In *American Professional Marketing*, distributors for defendant APMI earned bonuses based on purchases by distributors in their sales organizations. The State alleged that these bonuses were *per se* illegal under Iowa law. The Iowa Supreme Court disagreed, looking in substantial part to the lack of headhunting fees, inventory loading, and the existence of rules similar to the *Amway* safeguards.

investment in inventory is required to start or stay in the business; and a commercially reasonable inventory repurchase policy is offered. The Court should be aware of the effectiveness of and reliance which law enforcement, legislators, the public and direct selling companies have placed upon these features and safeguards, particularly the buyback provisions, as clear legal distinctions between bona fide marketing plans and pyramid schemes.

An effective and enforced buyback can eliminate the central ill of a pyramid scheme – inventory loading – by which participants are fettered with inventory they cannot sell and which they purchased in order to receive greater commissions or bonus payments. A buyback eliminates this possibility by ensuring that participants will be able to recoup most or all of their payments for the inventory. Thus, in a bona fide plan, the risk of loss to participants is minimal or nonexistent and the ability to perpetuate a pyramid scheme is effectively nullified.

Pyramids do not offer effective and enforced buybacks. Inventory repurchase policies have, in fact, become the chief mechanism to protect against inventory loading. Two states have recently adopted specific exclusions from their anti-pyramid statutes for companies which have effective buyback provisions similar to that found in *Amway*.[11] As of 1993, adoption of and adherence

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[11] *See*, Tex Bus. & Com. § 17.46(b), and Okla. Stat. Ann. tit. 21, § 1072. Five states and Puerto Rico also have mandatory buyback requirements for multilevel companies. Ga. Code Ann. § 10-1-415(d)(1); La. Admin. Code tit. 16, § III.501; Mass. Ann. Laws ch. 93, § 69(c) (Law Co-op); Md. Code Ann. Bus. Reg.

to just such a buyback became a condition of membership in the Direct Selling Association. Analysis of the *Amway* safeguards led the Association to conclude that the buyback was a clear-cut and unequivocal part of the difference between bona fide marketing plans and pyramid schemes. The buyback requirement was specifically adopted and incorporated into the DSA Code of Ethics, a document which already specifically prohibited pyramid schemes. Violation of the DSA Code can result in expulsion from the Association and referral of the matter to law enforcement officials.[12]

Indeed, an effective buyback has become a worldwide standard for prohibiting inventory loading and

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§ 14-302; Wyo. Stat. sec. 40-3-105; P.R. Laws Ann. tit. 10, sec. 997b.a.

[12] The DSA Code of Ethics, §§ 5 and 6, state:

> For the purposes of this Code, pyramid or endless chain schemes shall be considered consumer transactions actionable under this Code . . .
>
> Any member company with a marketing plan that involves selling products directly or indirectly to independent salespersons shall clearly state in its recruiting literature or contract with the independent salespeople that the company will repurchase on reasonable commercial terms currently marketable inventory in the possession of that salesperson and purchased by that salesperson for resale prior to the date of termination of the salesperson's business relationship with the company or its independent salespeople. For purposes of this Code, "reasonable commercial terms" shall include the repurchase of marketable inventory at not less than 90% of the salesperson's original net cost less appropriate set-offs and legal claims, if any.

encouraging sales to ultimate consumers. Several countries have adopted or are considering adoption of a national law which reflects the *Amway* buyback safeguard.[13] Similarly, the World Federation of Direct Selling Associations has adopted a worldwide code of ethics which requires adoption of the buyback.[14]

Since *Amway,* an effective and enforced buyback has been established as *the* principal standard to distinguish legitimate business activities from pyramid schemes.

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[13] *See, e.g.,* Competition Act, R.S.C. sec. 55 (1992) (Canada) (excluding companies with buybacks from the definition of a "scheme of pyramid selling"); C. Consumption Art. L. 122-6, 1995 (France) (requiring repurchase of inventory) (expanded upon in Ministere de L'Economie et des Finances, Direction Générale de la Concurrance, de la Consommation et de la Répression des Fraudes, Internal Note No. 6204, 18 Oct. 1995); Law on Retail Trade of 1996, ch. 22, 23 (Spain); Fair Trading Act, 1973, ch. 41; Pyramid Selling Schemes Regulation 1990, (SI 1989, No. 2195) (England).

[14] The World Federation of Direct Selling Associations (WFDSA) is made up by associations of direct selling companies in 42 countries, representing some 16 million salespeople generating over $63 billion in worldwide sales in 1994. In pertinent part, the WFDSA World Codes of Conduct (Towards Direct Sellers, Between Direct Sellers, and Between Companies) § B.g states:

> On the termination of a Direct Seller's relationship with a company, companies shall buy back any unsold but salable product inventory, including promotional material, sales aids and kits, and credit the Direct Seller's original net cost thereof less a handling charge to the Direct Seller up to 10% of the net purchase price and less any benefit received by the Direct Seller based on the original purchase of the returned goods.

Likewise, complementary rules similar in purpose and spirit to the 70% and ten customer rules in *Amway* have since been adopted by a number of companies to help manage inventory and encourage sales to ultimate consumers. These legitimate plans offer rewards based upon distribution of products to real consumers, and all who participate may assess for themselves the demand for their products and whether they will find a sufficient number of consumers to make their efforts profitable. A bona fide plan does not rely upon the large, up-front purchases of inventory of new participants to sustain it. Indeed, legitimate plans offer to repurchase inventory from participants who leave the plan. Plans which offer incentives, such as bonuses based on total purchases of a sales organization, together with the safeguards noted above, are commonplace in the direct selling industry. Indeed, last year multilevel marketing members of DSA reported sales in excess of an estimated $12 billion retail value in the U.S.

Unfortunately, in reversing the trial court's grant of summary judgment, the Court uses broad language in finding the defendant's compensation plan, on its face, to be a pyramid scheme. DSA's concerns relate primarily to the Court's suggestion that if rewards to participants are calculated based on orders (not actual retail sales) by downline participants, then a sales plan provides rewards "unrelated to the sale of products to the ultimate users" and might thereby be viewed as a pyramid under *Koscot*. The Court foregoes an initial *Amway* analysis, and thus could be read to effectively create a presumption which challenges the long-standing and legally accepted practices of many legitimate, bona fide marketing plans.

We believe that this view misconstrues the manner in which the *Amway* rules approved by the FTC work, would subject legitimate direct selling companies to unworkable recordkeeping and accounting requirements, and confuses the manner in which product and payments flow (and payments are calculated) under a sales plan with the nature of "ultimate rewards" of that plan. Indeed, it is doubtful whether a direct sales plan could function effectively (if at all) if companies or recruiting distributors were required to obtain information about all retail sales of participants. At best, this would involve great practical difficulty with monitoring potentially large sales organizations.

The Court should reconsider its analysis. It is DSA's strongly held view, based on existing legal precedents, that a marketing plan which calculates and pays compensation initially on the volume of inventory purchased by participants and which includes features to effectively avoid the ills associated with pyramid schemes is, on its face, valid. Reliance on orders and suggested retail prices to calculate rewards is simply a practical and efficient way to calculate the amount of those rewards; it is consistent with, not contrary to, the *Amway* standards and in no way suggests that the rewards are "unrelated to sales to ultimate users." That determination depends instead on whether a multilevel company has adopted and effectively enforces the *Amway* or similar safeguards. The burden is on a plaintiff to prove that the rules are not effectively enforced, or that a plan is deceptive. If the Court's language in the case instant were read broadly, it might be construed to effectively shift the burden to the defendants, suggesting henceforth that some companies

must as a matter of law prove their legitimacy. The Court should specifically reject this shift of the burden of proof to multilevel marketing companies. We believe it is vital that the Court reexamines its original analysis and affirm the existence and enforcement of the *Amway* safeguards, particularly the buyback, as clear demarcations between legitimate companies and pyramid schemes as part of any prima facie analysis of the issue.

II. PERSONAL USE OF THE PRODUCTS BY PLAN PARTICIPANTS IS AN IMPORTANT FACET OF MULTILEVEL MARKETING.

The Court's language might be read to misinterpret *Koscot* to prohibit the sales of products to participants in a multilevel marketing company and to prohibit any payment of compensation on the basis of participant purchases for personal consumption.[15] Any such interpretation would be inappropriate.

The obvious evil of a pyramid scheme is the defrauding of participants of valuable consideration. Most typically, as in *Koscot*, participants in an illegal pyramid pay large up-front investments, i.e., recruitment fees, which serve to compensate those higher up in the pyramid scheme. Many recruits ultimately will be unable to recoup those fees. As participation in the plan grows

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[15] "If Koscot is to have any teeth [a sale related to a distributor's use of the products] cannot satisfy the requirement that sales be to ultimate users of a product." *Webster*, 96 Daily Journal at 2429.

geometrically without any actual demand for the products the plan purports to sell, there is no viable economic engine to drive profits and payments for later-entering participants. Ultimately, the scheme collapses as the pool of available participants diminishes.

By way of contrast, in a legitimate multilevel marketing plan, any product purchased by a participant ultimately must either 1) be sold to another who consumes the product; 2) be consumed by the participant; or 3) be returned to the company. The risk of loss associated with pyramid schemes is simply not present in a legitimate marketing plan, and there is no reason compensation should not be paid based on a participant's total volume of business, including those products which have been consumed by the participants themselves.

Indeed, in DSA's view, the Court may properly take notice that consumption by participants of direct selling companies' products is a natural and appropriate element of direct sales. Many participants in direct selling plans of all types, including multilevel marketing, become interested in the plan only after becoming satisfied consumers of the products they now sell.[16] It is an axiom of direct

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[16] Sales to distributors and their use of a plan's products can be crucial to the success of a bona fide direct selling company. The first "customers" for many direct selling companies are their distributors. A 1992 survey of individuals involved in direct selling found that 90.7% of individual direct sellers entered direct selling because they liked and believed in the products. A 1995 industry-wide survey of direct selling companies found that personal consumption by salespeople and their families constituted nearly one third of 1994 retail direct sales by direct selling companies. 1995 Direct Selling Industry-

selling that a company must successfully market its products to its own distributors if it is to have any hope that its distributors will successfully market its products and its opportunity to others.

A bona fide marketing plan does not reward participants for the mere act of recruitment. Instead, as *Koscot* and *Amway* demand, it is only when the newly recruited distributor begins to make wholesale purchases from his sponsor or the company, and sales to consumers, that the sponsor begins to earn money from his recruits' sales efforts. *See, Amway,* 93 F.T.C. at 715-716. It is possible that in pyramid schemes a recruit's inventory purchases may be nothing more than a disguise for recruitment fees. However, in order for the fundamental evil of the pyramid scheme (i.e., defrauding of the participant of consideration paid) to succeed, that inventory purchase must be *nonreturnable.*[17]

Thus, a bona fide marketing plan whose participants make personal purchases and use of the product and are insulated from the possibility of substantial loss by the plan's inventory repurchase policy, does not violate *Koscot*. Statutory enactments have recognized as much.[18] It must be left to the trier of fact to determine whether, in reality, a plan's buyback is enforced and effective in preventing the possibility of substantial loss.

Wide Growth and Outlook Survey; 1992 Direct Selling Association Survey of Direct Sellers.

[17] *See, Amway,* at 715.

[18] *See,* Tex Bus. & Com. § 17.46(b), and Okla. Stat. Ann. tit. 21, § 1072.

In light of the fundamental marketing realities of the direct selling industry[19] the desires of its salespeople, and the ample protections which exist to prevent the pyramid evil of inventory loading, DSA urges that the Court should not use any analysis which could be misconstrued to prohibit distributor use of product or compensation based on distributor purchases.

CONCLUSION

DSA supports full and effective enforcement of the *Amway* standards to prevent pyramid sales organizations and recognizes that enforcement, not just adoption, of the *Amway* or similar standards is necessary to achieve that goal.

As the Court considers this case further, DSA urges it to do so in language that does not inadvertently and improperly undermine DSA members' ability to rely on reasonable standards, such as those in *Amway*. This will require recognition that the *Amway* standards may be satisfied, and rewards under the sales plan will remain

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[19] *See*, Thomas R. Wotruba, Direct Selling Education Foundation, *Moral Suasion, Development of the US Direct Selling Association Industry Code of Ethics* (1995); *Special Issue on Direct Selling, in J. of Marketing Channels* (Bert Rosenbloom ed., Feb. 1993); Wotruba, "Full-time vs. Part-Time Salespeople – A Comparison on Job Satisfaction, Performance and Turnover in Direct Selling." *Int'l. J. Research in Marketing*, Issue 7 (1990); Wotruba, "The Effect of Goal-Setting on the Performance of Independent Sales Agents in Direct Selling," IX *The J. of Personal Sales & Sales Mgm't*, (Spring 1990); Robert A. Peterson, et al., "Research Note: Consumers Who Buy From Direct Sales Companies," 65 *J. of Retailing* (Summer 1989).

"related to the sale of product to ultimate users," even if compensation or rewards to distributors are not calculated or based solely on actual retail sales. It will also require recognition that the *Amway* standards may be satisfied when rules (e.g., buyback, 70%, 10 retail customer, etc.) have the combined effect of avoiding compensation based solely on recruiting and of promoting and maintaining the sale of products to ultimate consumers. As authorities throughout the country and world now recognize, this is particularly true of an effective buyback rule, a key factor differentiating between a bona fide marketing plan and an illegal pyramid scheme.

DSA urges that any decision issued by the Court on this appeal avoid language which could be read to effectively shift the burden of proof to multilevel marketing companies, which have the protective characteristics described in *Amway*, to establish that they are legitimate. Plaintiffs must have the burden of establishing wrongdoing on the part of an alleged pyramid scheme. Further, the Court should recognize the procedural posture of the case and avoid any findings which could be construed to interpret or apply the *Amway* standards outside the context and limited record of this case.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that two copies of the foregoing BRIEF OF *AMICUS CURIAE* DIRECT SELLING ASSOCIATION IN SUPPORT OF PETITION FOR REHEARING AND SUGGESTION OF REHEARING EN BANC were sent by regular U.S. mail this 2d day of APRIL, 1996, to:

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